

**BACKGROUND AND PRESENT LAW RELATING
TO TAX SHELTERS**

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on March 21, 2002

Prepared by
the Staff of the
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

The Senate Committee on Finance has scheduled a hearing for March 21, 2002, on issues relating to tax shelters. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides background and a description of present law relating to tax shelters.

¹ This document may be cited as follows: Joint Committee on Taxation, *Background and Present Law Relating to Tax Shelters* (JCX-19-02), March 19, 2002.

I. BACKGROUND

The Internal Revenue Code (“Code”) provides specific rules regarding the computation of taxable income, including the amount, timing, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity and certainty to both taxpayers and the Government. Taxpayers generally may plan their transactions in reliance on these rules to determine the Federal income tax consequences arising from the transactions.

Notwithstanding the presence of specific rules for determining tax liability, a body of law has evolved in response to transactions that may comply with the literal language of a specific tax provision yet yield tax results that are unwarranted, unintended or inconsistent with the underlying policy of the provision. These transactions are euphemistically referred to as tax shelters.²

Perhaps no single topic in the Federal income tax laws has been as vexing and difficult to address as tax shelters. In 1934, Judge Learned Hand made the statement, often cited since, that a taxpayer

[M]ay so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.³

Since that time, taxpayers and tax administrators have struggled in determining the line between legitimate “tax planning” and unacceptable “tax shelters.” Even now, more than sixty-five years after Judge Hand’s opinion, there are disagreements on fundamental questions that lie at the heart of the tax shelter debate, such as the magnitude of the problem, why the problem exists, and appropriate responses to the problem. Scholars, policy advisors, and practitioners have written volumes of material on the topic,⁴ and several legislative proposals have been suggested in response to the problem.⁵ This pamphlet does not contain an analysis of the tax shelter

² Professor Michael Graetz once defined a tax shelter as “a deal done by very smart people that, absent tax considerations, would be very stupid.” See Tom Herman, *Tax Report*, Wall St. J. at A-1 (Feb. 10, 1999).

³ *Helvering v. Gregory*, 69 F. 2d 809, 810 (2nd Cir. 1934), *aff’d* 293 U.S. 465 (1935).

⁴ See, e.g., Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99), July 22, 1999 (the “Joint Committee staff study”); Department of the Treasury White Paper: *The Problem of Corporate Tax Shelters (Discussion, Analysis and Legislative Proposals*, (July 1999); Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters*, 54 SMU L. Rev. 1 (2001).

⁵ *Id.* See also, *Discussion Draft of the “Tax Shelter Disclosure Act,”* released by the Staff of the Senate Committee on Finance on August 3, 2001 (107th Cong., 1st Sess.), available at 2001 TNT 151-58 (Aug. 6, 2001); *Revised Discussion Draft on Tax Shelters*, released by the Staff of

problem⁶ nor does it analyze any of the legislative proposals. Rather, it provides a summary of the existing body of law, authorities, and standards that are relevant to the topic of tax shelters.

the Senate Committee on Finance on October 5, 2000 (106th Cong., 2d Sess.), available at 2000 TNT 195-8 (Oct. 6, 2000); *Discussion Draft on Tax Shelters*, released by the Staff of the Senate Committee on Finance on May 24, 2000, available at 2000 TNT 102-9 (May 25, 2000); H.R. 2520, the “Abusive Tax Shelter Shutdown Act of 2001,” introduced by Mr. Doggett and others on July 17, 2001 (107th Cong., 1st Sess.); Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2001 Revenue Proposals*, at 122-28 (February 2000).

Most recently, Assistant Treasury Secretary (Tax Policy) Mark Weinberger announced that the Bush Administration is prepared to offer specific legislative recommendations that are designed to curb corporate tax shelters. See, Katherine Stimmel, “*Treasury Ready to Offer Legislative Proposals At Finance Hearing on Shelters, Official Says*,” BNA Tax Report, No. 53, at GG-1 (March 19, 2002).

⁶ For the Joint Committee staff analysis of the tax shelter problem, see Part VIII of the Joint Committee staff study, *supra* note 4, at 177-259; see also, Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Concerning Corporate Tax Shelters Before the Senate Committee on Finance, March 8, 2000* (JCX-23-00), March 7, 2000.

II. PRESENT LAW

A. Present Law Principles Applied to Tax Shelters

Under present law, there is no uniform standard as to what constitutes a tax shelter; however, there are statutory provisions, judicial doctrines, and administrative guidance that attempt to limit or identify transactions in which a significant purpose is the avoidance or evasion of income tax.⁷

1. Selected statutory provisions limiting tax benefits in certain transactions

Section 269

If a taxpayer engages in certain transactions for the principal purpose of evading or avoiding Federal income tax by securing the benefit of a deduction, credit, or other allowance that would not otherwise have been available, the Secretary of the Treasury (the “Secretary”) has the authority to disallow the resulting benefits. The Secretary may only exercise this special authority with respect to three defined transactions: (1) if any person or persons acquire, directly or indirectly, control (defined as at least 50 percent of vote or value) of a corporation; (2) if a corporation acquires, directly or indirectly, property of another corporation (not controlled, directly or indirectly, by the acquiring corporation or its stockholders) where the basis of the property is determined by reference to the basis in the hands of the transferor corporation; or (3) if a corporation acquires at least 80 percent control (measured by both vote and value, but excluding certain nonvoting preferred stock) of another corporation, an election pursuant to section 338 is not made, and the acquired corporation is liquidated pursuant to a plan of liquidation adopted within two years after the acquisition date.

Because “tax shelter” transactions sometimes involve securing the benefits of deductions, credits, or other allowances to tax shelter participants, section 269 may apply to deny the anticipated tax benefits, to the extent that the transaction involved is of the type described above.

Section 446

Section 446(b) provides that if a taxpayer’s method of accounting does not clearly reflect income, taxable income shall be computed under the method that, in the opinion of the Secretary,

⁷ In addition, the Code defines tax shelters in a variety of contexts. For example, section 6662(d)(2)(C)(iii) defines a tax shelter for purposes of the understatement penalty (discussed in Part B.1. of the text); section 6111(a) imposes a registration requirement with respect to certain tax shelters (see definition below); section 461(i)(3) defines a tax shelter for purposes of certain tax accounting rules as (1) an enterprise (other than a C corporation), the interests in which have been offered for sale in an offering required to be registered with a Federal or State securities agency, (2) a syndicate (a partnership or other entity, other than a corporation that is not an S corporation, if more than 35 percent of the losses of the entity are allocable to limited partners or limited entrepreneurs), and (3) a tax shelter (as defined in section 6662(d)(2)(C)(iii)); and section 448(d)(3) generally adopts the section 461(i)(3) definition of a tax shelter for purposes of limiting the application of the cash method of accounting.

does clearly reflect income. The Secretary has broad discretion to determine whether a method of accounting clearly reflects income.⁸ As the Tax Court in *ACM v. Commissioner* observed, “a taxpayer’s method of accounting does not clearly reflect income when it does not represent ‘economic reality.’”⁹ Thus, to the extent that a corporate tax shelter involves deferrals of income or acceleration of deductions or basis recovery, or otherwise involves methods of accounting, the Secretary may employ section 446 as a substantive means to modify the taxpayer’s method of accounting in order to clearly reflect income.

Section 482

Section 482 provides that when two or more entities are controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among the entities in order to prevent the evasion of taxes or to reflect clearly the income of an entity. The Internal Revenue Service (“IRS”) may assert section 482 as authority to respond to tax shelters that involve the misallocation of income among different business entities.

In order to apply section 482 with respect to corporate tax shelters, the transaction in question must involve transfers between or among “two or more entities . . . controlled . . . by the same interests”¹⁰ However, the IRS has adopted a broad interpretation of what it means to be controlled for this purpose. Acting in concert to avoid taxes may cause two unrelated entities to be considered part of the same controlled group.¹¹

The breadth of the section 482 definition of a control group is illustrated by the Ninth Circuit case, *Paccar, Inc. v. Commissioner*.¹² In *Paccar*, an independent warehouse company was established solely to provide its customers with tax write-offs, pursuant to old inventory accounting rules. The independent warehouse company’s only business purpose was to engage in transactions with tax avoidance clients, including unimportant nontax-related services to those clients. The Ninth Circuit held that the warehouse company was controlled by its clients and that its transactions lacked economic substance. Therefore, the court upheld the Commissioner’s redetermination of the petitioner’s tax liability pursuant to section 482.

Three Field Service Advice Memoranda addressing certain lease stripping transactions (which are intended to allow one party to realize income from a lease and another party to report

⁸ *Thor Power Tool v. Commissioner*, 439 U.S. 522, 531 (1979); *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959); *Ferrill v. Commissioner*, 684 F.2d 261, 263 (3d Cir. 1982).

⁹ *ACM Partnership v. Commissioner*, 73 T.C.M. (CCH) 2189, 2214 (1997) (dictum) (citing *Prabel v. Commissioner*, 882 F.2d 820, 826-27 (3d Cir. 1989)), *aff’d* 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

¹⁰ Sec. 482.

¹¹ Treas. Reg. sec. 1.482-1(i)(4).

¹² 849 F.2d 393 (9th Cir. 1988), *aff’g* 85 T.C. 754 (1985).

depreciation deductions relating to the income) illustrate the IRS's use of section 482 as a substantive rule in connection with transactions for which the IRS also raised the sham transaction and economic substance doctrines.¹³ Thus, in certain circumstances, section 482 provides the IRS with a statutory mechanism for addressing tax shelter activity.

Section 469

The rules of section 469, known as the passive loss rules, limit deductions and credits from passive trade or business activities. The rules were enacted in 1986 to curb the growth of tax shelters, primarily for individuals.¹⁴ Under the passive loss rules, deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

The passive loss rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income. Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. Rental activities (including rental real estate activities) generally are also treated as passive activities, regardless of the level of the taxpayer's participation.¹⁵

¹³ Field Service Advice Memoranda 199920012 (May 21, 1999), 199914018 (Apr. 12, 1999), and 199909005 (Mar. 8, 1999).

¹⁴ In setting forth the reasons for the passive loss rules, Congress stated, ". . . the [Senate Finance] committee believes that decisive action is needed to curb the expansion of tax sheltering and to restore to the tax system the degree of equity that is a necessary precondition to a beneficial and widely desired reduction in rates. So long as tax shelters are permitted to erode the Federal tax base, a low-rate system can provide neither sufficient revenues, nor sufficient progressivity, to satisfy the general public that tax liability bears a fair relationship to the ability to pay. In particular, a provision significantly limiting the use of tax shelter losses is unavoidable if substantial rate reductions are to be provided to high-income taxpayers without disproportionately reducing the share of total liability under the individual income tax that is borne by high-income taxpayers as a group." S. Rep. No. 99-313 (1986) at 714.

¹⁵ A special rule permits the deduction of up to \$25,000 of losses from rental real estate losses in which the taxpayer actively participates; the deduction amount is phased out for taxpayers with adjusted gross incomes between \$100,000 and \$150,000. In addition, under a special rule, a taxpayer's rental real estate activities in which he materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which he performs services.

Section 7701(l)

Section 7701(l) provides the IRS with the authority to address tax shelter arrangements involving financing transactions. It provides: “[t]he Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent [the] avoidance of . . . tax” The subsection authorizes Treasury to prescribe regulations to deal generally with complicated, tax-motivated lending transactions that lack economic substance.¹⁶ In January 2000, the IRS finalized regulations pursuant to section 7701(l) to eliminate the abuse of “step down” or “fast pay” preferred stock.¹⁷ Earlier, the IRS proposed regulations to deal with lease stripping transactions, and issued final regulations dealing with certain conduit financing arrangements.¹⁸

2. Judicial doctrines

Overview

In addition to the statutory provisions, the courts have developed several doctrines over the years to deny certain tax motivated transactions their intended tax benefits. These doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS.¹⁹ There is considerable overlap among the doctrines, and typically more than one doctrine is likely to apply to a transaction. Because of these considerations, invocation of these doctrines can be seen as at odds with an objective, “rule-based” system of taxation. Nonetheless, the doctrines have been applied to invalidate some of the transactions believed to create the most egregious abuses.²⁰

The Supreme Court has made it clear that “[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.”²¹ When a taxpayer, however, “crosses the line” such that what was done, apart from tax motive, was not the thing which the statute intended, the tax advantage

¹⁶ See, e.g., *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971).

¹⁷ Treas. Reg. sec. 1.7701(l)-3.

¹⁸ Prop. Treas. Reg. sec. 1.7701(l)-2; Treas. Reg. sec. 1.881-3.

¹⁹ A recent example of a case where the judicial doctrines appear to have been blurred is *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001), *rev’g* 78 T.C.M. (CCH) 262 (1999) (discussed below in connection with the sham transaction doctrine).

²⁰ See, e.g., *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff’g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999) .

²¹ *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), *aff’g* 69 F.2d 809 (2d Cir. 1934).

should be denied.²² The general doctrines used to deny such tax benefits are (1) the sham transaction doctrine, (2) the economic substance doctrine, (3) the business purpose doctrine, (4) the substance over form doctrine, and (5) the step transaction doctrine.²³

Sham transaction doctrine

Sham transactions are those in which the economic activity that is purported to give rise to the desired tax benefits does not actually occur. The transactions have been referred to as “facades” or mere “fictions”²⁴ and, in their most egregious form, one may question whether the transactions might be characterized as fraudulent.

Although the sham transaction doctrine generally applies when the purported activity giving rise to the tax benefits does not actually occur (a “sham in fact”), in certain circumstances, a transaction may be found to constitute a sham even when the purported activity does occur. For example, if a transaction is entered into to generate a loss for the taxpayer, and the taxpayer’s risk with respect to the transaction has been eliminated through a guarantee by a broker (such that the only economic consequences to the taxpayer will be the desired tax benefits), the transaction may be found to be “in substance” a sham.²⁵ In some situations, a court may find that a transaction is both a sham in fact and a sham in substance.²⁶ The two facets of the sham transaction doctrine has been described as follows:

²² *Gregory*, 293 U.S. at 469.

²³ The *Gregory* case often is cited as the seminal case with respect to several of these doctrines, especially the sham transaction, economic substance, and business purpose doctrines. For a general discussion of these doctrines, see Symposium: *Business Purpose, Economic Substance and Corporate Tax Shelters*, *supra* note 4; Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax Motivated Transactions*, 59 *Taxes* 985 (1981); and David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 *Tax Law.* 235 (1999).

²⁴ See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960) (disallowing deduction for prepaid interest on a nonrecourse, riskless loan used to purchase deferred-annuity savings bonds). See also, *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313 (11th Cir. 2001), *aff’d* 113 T.C. 254 (1999) (relying on *Knetsch* in applying the sham transaction doctrine to disallow an interest expense under section 163 in connection with the taxpayer’s corporate-owned life insurance program even though the interest deduction was not prohibited by section 264); *American Electric Power v. United States*, 136 F. Supp. 2d 762 (E. D. Ohio 2001) (same except that the sham transaction doctrine was invoked to disallow the interest deduction under section 264(a)(3)).

²⁵ See, e.g., *Yosha v. Commissioner*, 861 F.2d 494 (7th Cir. 1988) (holding options straddles to be shams because the broker insured the clients against market risk).

²⁶ See, e.g., *IRS v. CM Holdings, Inc. (In re CM Holdings Inc.)*, 254 B.R. 578 (D. Del. 2000) (interest deductions disallowed, and accuracy related penalty imposed, in connection with

Courts have recognized two basic types of sham transactions. Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.²⁷

The Winn-Dixie case

A recent case involving the application of the sham transaction doctrine is *Winn-Dixie Stores, Inc. v. Commissioner*.²⁸ In 1993, Winn-Dixie entered into a company-owned life insurance (COLI) program on the lives of its 36,000 employees. Under the program, Winn-Dixie purchased whole-life insurance policies and was the sole beneficiary. Winn-Dixie borrowed periodically against the policies' account value at interest rates that averaged 11 percent. The 11-percent average interest rate, when coupled with the administrative fees, outweighed the net cash surrender value and benefits paid on the policy. Thus, although Winn-Dixie lost money on the program each year, the tax deductibility of the interest and fees yielded a benefit of several billion dollars over 60 years. In 1997, Winn-Dixie terminated its participation in the COLI program following the enactment of tax law changes in 1996 that limited the deductibility of interest on COLI policy loans.²⁹ On audit, the IRS disallowed the deductions for interest and administrative fees that Winn-Dixie claimed on its 1993 tax return with respect to its COLI program and COLI policy loans.

On petition to the Tax Court, Winn-Dixie argued that the deductions relating to its COLI program were proper because: (1) the COLI program satisfied the business purpose and economic substance prongs of the sham transaction doctrine, and (2) in any case, the sham transaction doctrine was inapplicable because Congress explicitly authorized the deductions in connection with the COLI program. However, the Tax Court sustained the IRS disallowance of the COLI-related deductions claimed by Winn-Dixie, concluding that the COLI program (including the associated policy loans) was a sham.

In arguing that its COLI program had a business purpose and economic substance, Winn-Dixie asserted that it used the earnings from the COLI program to fund the flexible benefits program that it provided to its full-time employees.³⁰ However, the Tax Court determined that the COLI program lost money on a pre-tax basis, and that the program generated positive

a taxpayer's corporate-owned life insurance program that was found to be a sham in fact and a sham in substance).

²⁷ *United Parcel Service of America, Inc. v. Commissioner*, 78 T.C.M. (CCH) 262 at n. 29 (1999), *rev'd* 254 F.3d 1014 (11th Cir. 2001), *citing* *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989), *aff'g* *Glass v. Commissioner*, 87 T.C. 1087 (1986).

²⁸ *Winn-Dixie*, 113 T.C. 254 (1999), *aff'd* 254 F.3d 1313 (11th Cir. 2001).

²⁹ *See* Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, sec. 510, 110 Stat. 2090 (1996).

³⁰ *Winn-Dixie*, 113 T.C. at 286.

earnings and cash flow only on an after-tax basis after taking into account the deductions for interest and administrative costs. Thus, the court concluded that the COLI program was a sham:

Even if we were to accept [the testimony of Winn-Dixie's financial vice president] that he intended to use tax savings to fund [Winn-Dixie's flexible benefits program], that would not cause the COLI plan to have economic substance. If this were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, every sham tax-shelter device might succeed. Petitioner's benefit from the COLI plan was dependent on the projected interest and fee deductions that would offset income from petitioner's normal operations. The possibility that such tax benefits could have been used as a general source of funds for petitioner's [flexible benefits program] obligations (or any other business purpose) does not alter the fact that the COLI plan itself had only one function and that was to generate tax deductions which were to be used to offset income from its business and thereby reduce petitioner's income tax liabilities in each year.³¹

With regard to whether Congress sanctioned the deductibility of interest and costs relating to COLI programs, Winn-Dixie argued that the sham transaction doctrine was not pertinent to its COLI program because Congress has repeatedly addressed the treatment of COLI plans over the years and has permitted deductions attributable to certain COLI plans that either satisfied explicit statutory requirements or predated the enactment of legislation to restrict such deductions.³² However, the Tax Court concluded that any legislative approval of COLI programs was premised upon programs that had economic substance and were not shams:

It is clear that Congress and the Treasury Department were aware of the problems associated with interest deductions on life insurance loans. However, we are not persuaded that Congress, by enacting and amending section 264 or other related provisions that restrict the deductibility of interest, intended to allow interest deductions under section 163 based on transactions that lacked with economic substance or business purpose. In *Knetsch*, the Supreme Court noted that nothing in the legislative history of section 264 suggests that Congress intended to protect sham transactions. Similarly, we find nothing in the more recent legislative history of section 264 suggesting that Congress intended to allow deductions arising from sham transactions that lacked economic substance and business purpose.³³

³¹ *Id.* at 287-288 [footnote omitted].

³² *Id.* at 290. Section 264(a)(3) generally provides that no deduction is allowed for amounts paid or accrued on indebtedness incurred to purchase a life insurance contract if such debt was incurred pursuant to a plan of purchase that contemplates the systematic borrowing of increases in the cash value of the insurance contract. Section 264(c)(1) provides an exception if no part of any four annual premiums due in the first seven-year period of an insurance contract is financed by indebtedness.

³³ *Winn-Dixie*, at 293-294.

Accordingly, the Tax Court upheld the disallowance by the IRS of the deductions claimed by Winn-Dixie for interest and administrative costs relating to its COLI program. On appeal, the Eleventh Circuit Court of Appeals adopted the reasoning of the Tax Court and affirmed its decision.³⁴

The UPS case

The assertion of the sham transaction doctrine to situations in which the activity in fact occurred (i.e., shams in substance) and the inherent overlap with the economic substance and business purpose doctrines (described below), has proven troublesome to some courts. This was recently illustrated by the Eleventh Circuit's reversal of the Tax Court in *United Parcel Service of America, Inc. ("UPS") v. Commissioner*.³⁵

The *UPS* case involved an arrangement between UPS and a related Bermuda corporation relating to certain insurance premiums on packages that UPS shipped. As part of its basic shipping contract, UPS insured its customers for up to \$100 of value per package at no extra charge. UPS also offered its customers "excess value" insurance, pursuant to which customers could purchase additional insurance at a price of 25 cents for every additional \$100 of insured value. Prior to establishing the arrangement at issue in the case, UPS self-insured these risks, earning the premium income, bearing the losses, and administering the claims itself. Under the arrangement with the Bermuda corporation, UPS collected the excess value premiums and paid them, through a ceding arrangement with an unrelated insurance company, to the Bermuda corporation. In return, the risks were reinsured by the Bermuda corporation, those risks having first been insured by the unrelated insurance company. Although the insurance business ostensibly had been transferred to the Bermuda corporation, UPS continued to administer the excess value insurance and pay the claims itself, despite the fact that the premium income had been shifted to the Bermuda corporation. The Tax Court disregarded the arrangement and attributed all of the Bermuda corporation's income to UPS, on the basis that the Bermuda corporation had not in fact earned the income -- an application of the sham transaction doctrine (as well as elements of the economic substance, business purpose, and assignment-of-income doctrines).

The Eleventh Circuit reversed the Tax Court, finding that the arrangement did have economic substance and therefore was not a sham. The court noted that the arrangement involved the assumption of genuine obligations by an unrelated insurance company, and the transfer of the excess value insurance business to the Bermuda corporation meant that UPS could no longer use the income stream generated from the business for its corporate purposes. The court relied on these factors to "distinguish UPS's case from the paradigmatic sham transfers of income, in which the taxpayer retains the benefits of the income it has ostensibly forgone."³⁶

³⁴ 254 F.3d 1313 (11th Cir. 2001) (per curiam).

³⁵ 254 F.3d 1014 (11th Cir. 2001), *rev'g* 78 T.C.M. (CCH) 262 (1999).

³⁶ *UPS*, 254 F.3d at 1019.

However, the court remanded the case for determinations under the more specific statutory reallocation provisions of sections 482 and 845(a).

Economic substance doctrine

In general

The courts generally will deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity did actually occur. The Tax Court has described the doctrine as follows:

The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.³⁷

The seminal authority most often credited for laying the foundation of the economic substance doctrine is the Supreme Court and Second Circuit decisions in *Gregory v. Helvering*.³⁸ In *Gregory*, a transitory subsidiary was established to effectuate, utilizing the corporate reorganization provisions of the Code, a tax advantaged distribution from a corporation to its shareholder of appreciated corporate securities that the corporation (and its shareholder) intended to sell. Although the Tax Court found that the transaction satisfied the literal definition of a tax-free reorganization, the Second Circuit held (and the Supreme Court affirmed) that satisfying the literal definition was not enough:

[T]he underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholder's taxes is not one of the transactions contemplated as corporate "reorganizations."³⁹

Since the time of *Gregory*, several cases have denied tax benefits on the grounds that the subject transactions lacked economic substance.⁴⁰ The economic substance doctrine can apply

³⁷ *ACM*, 73 T.C.M. at 2215.

³⁸ 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

³⁹ *Gregory*, 69 F.2d at 811.

⁴⁰ *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960); *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacks economic substance); *Sheldon v. Commissioner*, 94 T.C. 738 (1990) (holding that a marginally profitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacks economic substance, and imposing penalties); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacks economic substance).

even when a taxpayer is exposed to risk and where there is some profit potential (i.e., where the transactions are real) if the facts suggest that the economic risks and profit potential were insignificant when compared to the tax benefits.⁴¹ In other words, the doctrine suggests a balancing of the risks and profit potential as compared to the tax benefits in order to determine whether the transactions had “purpose, substance or utility apart from their anticipated tax consequences.”⁴²

The ACM case

An application of the economic substance doctrine in the corporate context is well illustrated by the Tax Court and Third Circuit opinions in *ACM Partnership v. Commissioner*.⁴³ *ACM* involved an intricate plan designed to create losses where the offsetting gains would escape U.S. taxation.

In *ACM*, Colgate-Palmolive Company (“Colgate”) reported a sizeable capital gain in 1988 (approximately \$105 million) from its sale of a subsidiary. Colgate wanted to avoid or minimize paying Federal income tax on that gain.⁴⁴ The transaction originated with a proposal that Merrill Lynch presented to Colgate in 1989 involving the formation of a partnership with a foreign bank to engage in the purchase and sale of short-term securities. By virtue of the application of the special ratable basis recovery rules under section 453 (described below), the proposal was designed to generate a large gain in the first year that would be allocated primarily to the foreign bank (with no U.S. tax consequences to the bank). The foreign bank’s interest in the partnership then would be redeemed, and losses would be generated in subsequent years that

⁴¹ See *Goldstein v. Commissioner*, 364 F.2d 734, 739-40 (2d Cir. 1966) (disallowing deduction even though taxpayer has a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, “potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions”).

⁴² *Goldstein*, 364 F.2d at 740. Even this articulation of the economic substance doctrine will fall short in its application to some sets of facts. For example, taxpayers motivated solely by tax considerations have been permitted by the courts to time their recognition of accrued economic losses, notwithstanding that the IRS attacked such tax-motivated transactions as lacking economic substance. See, e.g., *Cottage Savings v. Commissioner*, 499 U.S. 554 (1991) (allowing losses, pursuant to section 1001(a), on exchanges of substantially identical mortgages); *Doyle v. Commissioner*, 286 F.2d 654 (7th Cir. 1961). In *Doyle*, the IRS argued that the taxpayer’s use of a straddle to recognize loss on its stock without taking itself out of its ownership in the stock lacked economic substance; the court held that transactions were at arm’s length and, therefore, bona fide so that the losses were allowed under section 165.

⁴³ 157 F.3d 231 (3d Cir. 1998), *aff’d* 73 T.C.M. (CCH) 2189 (1997), *cert. denied*, 526 U.S. 1017 (1999).

⁴⁴ *ACM*, 73 T.C.M. at 2191.

would be allocated almost entirely to Colgate (which would carry back the losses to offset the capital gain from the sale of its subsidiary).

Colgate initially had reservations with respect to the Merrill Lynch proposal because it did not seem to serve Colgate's business purposes.⁴⁵ However, Colgate became interested in using the partnership to invest in its own debt in order to rebalance its debt portfolio.⁴⁶ Colgate's debt acquisition objectives were then incorporated into the tax reduction strategy.

To accomplish its goal, in November 1989, Colgate (through a subsidiary) formed a partnership ("ACM") with a foreign subsidiary of Algemene Bank Nederlands ("ABN") N.V. (a Dutch bank), and a subsidiary of Merrill Lynch. Each partner contributed cash. At the outset, ABN held an 82.6 percent interest in the partnership, Colgate held a 17.1 percent interest and Merrill Lynch a 0.3 percent interest. The total contributions to the partnership were \$205 million.

At the end of November 1989, ACM paid \$205 million to purchase floating-rate notes that were paying interest at a rate that was only three basis points above the rate the funds were already earning in deposit accounts. The interest rates on the floating-rate notes were scheduled to reset only once a month, and ACM had prearranged to dispose of the notes in a 24-day period encompassing only one interest rate adjustment and virtually guaranteeing that ACM would have no real exposure to interest rate or principal value fluctuations with respect to the notes.⁴⁷ Twenty-four days later, ACM sold \$175 million of the floating-rate notes in exchange for \$140 million in cash plus installment notes worth an estimated \$35 million. The installment notes provided for six semiannual payments equal to a notional principal amount multiplied by the London Interbank Offering Rate ("LIBOR").⁴⁸ The LIBOR notes were treated as contingent and, therefore, subject to the special ratable basis recovery rule under the section 453 regulations.⁴⁹

With respect to the \$175 million of notes sold in 1989, in accordance with the special section 453 ratable basis recovery rule, ACM recovered only \$29 million of its basis and

⁴⁵ *Id.*

⁴⁶ *Id.* at 2192.

⁴⁷ *ACM*, 157 F.3d at 250 and n.35.

⁴⁸ *ACM*, 73 T.C.M. at 2191.

⁴⁹ Temp. Treas. Reg. sec. 15A.453-1(c)(3)(i) provides:

When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer's basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.

therefore reported a \$111 million capital gain, most of which was allocated to the foreign partner that was not subject to U.S. tax.⁵⁰

In 1991, pursuant to a preconceived plan, Colgate purchased part of ABN's interest in ACM, and ACM redeemed the remainder of ABN's interest, leaving Colgate with a 99.7 percent interest. Subsequent to redeeming the foreign partner (and pursuant to the same plan), ACM sold the LIBOR notes for \$11 million, recognizing a capital loss of \$85 million as a result of the special ratable basis recovery rules. Virtually all of this loss was allocated to Colgate. Hence, if given effect for tax purposes, the transaction would have generated a capital loss producing a tax refund for Colgate (after carryback to offset its capital gain from the sale of its subsidiary) and an offsetting capital gain (to the former foreign partner) that escaped U.S. taxation.

Both the Tax Court and the Third Circuit Court of Appeals held that the transaction lacked economic substance. The Third Circuit held that “both the objective analysis of the actual economic consequences of ACM’s transactions and the subjective analysis of their intended purposes support the Tax Court’s conclusion that ACM’s transactions did not have sufficient economic substance to be respected for tax purposes.”⁵¹ The court observed that the economic substance doctrine can apply equally to “shams in substance” as “shams in fact” and that even if the purported activity in the transaction actually occurs, the transaction may be disregarded when (other than tax consequences) the transaction results in “no net change in the taxpayer’s economic position.”⁵² In other words, as an objective matter, to be respected for tax purposes, a transaction must have practical economic effects other than the creation of tax losses.⁵³ The court found that there was “a lack of objective economic consequences arising from ACM’s offsetting acquisition and virtually immediate disposition of the [floating-rate] notes. . . . [W]e find that these transactions had only nominal, incidental effects on ACM’s net economic position.”⁵⁴

The court stated that economic substance is a prerequisite to sustaining a transaction (and that the transaction in question did not satisfy the prerequisite):

In order to be deductible, a loss must reflect actual economic consequences sustained in an economically substantive transaction and cannot result solely from the application of a tax accounting rule to bifurcate a loss component of a transaction from its offsetting gain component to generate an artificial loss, which, as the Tax Court found, is “not economically inherent in” the transaction. 73 T.C.M. at 2215. . . . Based on our review of the record regarding the objective economic consequences of ACM’s short-swing, offsetting investment in and

⁵⁰ *ACM*, 73 T.C.M. at 2213.

⁵¹ *ACM*, 157 F.3d at 248.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 250.

divestment from the [floating-rate] notes, we find ample support for the Tax Court’s determination that ACM’s transactions generated only “phantom losses” which cannot form the basis of a capital loss deduction under the Internal Revenue Code.⁵⁵

Finally, in addition to finding that the transaction lacked objective economic substance, the court held that to be respected for tax purposes, a transaction must have a subjective non-tax objective. The court found that the ACM transaction did not satisfy this test:

While ACM purported to combine the tax avoidance objective of Merrill Lynch’s initial May 1989 proposal with the nontax debt acquisition objectives incorporated into subsequent proposals, ACM’s pursuit of these two distinct objectives within the same partnership cannot obscure the fact that the contingent installment exchange, which was solely responsible for the tax consequences at issue, was executed independently of, did not further, and in fact impeded ACM’s pursuit of its nontax debt acquisition objectives Thus, the nontax motivations behind ACM’s debt purchase do not alter the fact that the contingent installment sale was motivated only by tax avoidance purposes.⁵⁶

In short, the Third Circuit held that a transaction must have sufficient objective economic substance and subjective business motive to be respected for tax purposes, and the ACM transaction lacked both.

ASA Investerings

The Government has successfully litigated other cases involving contingent installment sale transactions that were substantially identical to the transaction at issue in the *ACM* case. However, the decisions in some of these other cases have relied on different rationales. In *ASA Investerings Partnership v. Commissioner*,⁵⁷ AlliedSignal, Inc., realized capital gains of approximately \$446 million in 1990 from the sale of its interest in an oil, gas, and petrochemical company. In anticipation of realizing these capital gains, AlliedSignal entered into a contingent installment sale transaction proposed by Merrill Lynch that generated capital losses to offset the capital gains. Similar to the transaction at issue in *ACM*, a newly formed subsidiary of AlliedSignal formed a partnership with newly formed subsidiaries of Merrill Lynch and ABN, N.V. The partnership (*ASA Investerings*) carried out a prearranged plan to purchase and later sell floating-rate notes that took advantage of the contingent installment sale rules⁵⁸ to generate capital losses that were allocated to AlliedSignal. On audit, the IRS disallowed the capital losses claimed by AlliedSignal. As in *ACM*, the Tax Court in *ASA* sustained the disallowance of the

⁵⁵ *Id.* at 252.

⁵⁶ *Id.* at 256 n.48.

⁵⁷ 76 T.C.M. (CCH) 325 (1998), *aff’d*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000).

⁵⁸ Temp. Treas. Reg. 15A.453-1, cited *supra*, note 49.

claimed capital losses. Unlike *ACM*, however, the Tax Court did not engage in an analysis of whether the transaction in question had economic substance. Instead, the Tax Court found that the parties to the transaction “did not have the requisite intent to join together for the purpose of carrying on a partnership and sharing the profits and losses therefrom.”⁵⁹ Thus, the court disregarded the existence of the partnership for tax purposes and concluded that ABN, N.V. (the primary contributor of cash to the purported partnership upon formation) was not a partner with AlliedSignal but, rather, a creditor of AlliedSignal.

On appeal, the D.C. Circuit Court of Appeals affirmed the Tax Court, although it did not discuss the basic analytical issue concerning whether a transaction should be examined initially for economic substance or only after determining that it complies with the technical requirements of the statutory tax rules. However, the court did suggest that a more focused inquiry into the specific facts surrounding a transaction should be undertaken before resorting to an economic substance analysis:

We note that the “business purpose” doctrine is hazardous. It is uniformly recognized that taxpayers are entitled to structure their transactions in such a way as to minimize tax. When the business purpose doctrine is violated, such structuring is deemed to have gotten out of hand, to have been carried to such extreme lengths that the business purpose is no more than a façade. But there is no absolutely clear line between the two. Yet the doctrine seems essential. A tax system of rather high rates gives a multitude of clever individuals in the private sector powerful incentives to game the system. Even the smartest drafters of legislation and regulation cannot be expected to anticipate every device. The business purpose doctrine reduces the incentive to engage in such essentially wasteful activity, and in addition helps achieve reasonable equity among taxpayers who are similarly situated--in every respect except for differing investments in tax avoidance.

Thus the Tax Court was, we think, sound in its basic inquiry, trying to decide whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance.⁶⁰

Saba Partnership

In *Saba Partnership v. Commissioner*,⁶¹ Brunswick Corporation had realized capital gains of approximately \$115 million in 1990, primarily as a result of the sale of various businesses. Based upon a proposal from Merrill Lynch, Brunswick entered into a contingent installment sale transaction that generated capital losses to offset the otherwise taxable capital gains realized by Brunswick in 1990. Like the transactions involved in *ACM* and *ASA*

⁵⁹ 76 T.C.M. (CCH) at 335. *See* sec. 761, which defines a partnership for tax purposes as “a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.”

⁶⁰ 201 F.3d at 513.

⁶¹ 78 T.C.M. (CCH) 684 (1999), *vacated and remanded*, 273 F.3d 1135 (D.C. Cir. 2001).

Investerings, newly formed subsidiaries of Merrill Lynch and ABN, N.V. joined with a newly formed subsidiary of Brunswick to form a partnership.⁶² The partnership purchased and shortly thereafter sold floating-rate notes pursuant to a prearranged plan that generated capital losses that were allocated to Brunswick.⁶³

On audit, the IRS disallowed the capital losses claimed by Brunswick, and the Tax Court sustained the disallowance on the grounds that the contingent installment sale transaction lacked a valid non-tax business purpose and had no economic substance. With regard to the purported business purposes of the transaction, the court concluded that “the proffered business purposes amount to little more than window dressing for transactions that were designed and implemented solely to generate tax benefits for Brunswick.”⁶⁴ As for economic substance, the Tax Court found that “no reasonable business person would have participated in the [contingent installment sale] transactions, as they were designed and implemented in these cases, except for a tax motive.”⁶⁵ The court also stated that “[t]he intricate manipulation of the contingent installment sales rules in this case could not conceivably be the type of economically sterile transaction Congress intended to sanction.”⁶⁶ Because it determined that the overall transactions had no valid non-tax business purpose and no economic substance, the court did not analyze an alternative argument made by the Government that the partnerships formed as part of the transaction were themselves not valid partnerships and should not be respected for tax purposes.

Following its decision in *ASA*, the D.C. Circuit Court of Appeals considered an appeal from Brunswick in the *Saba* case.⁶⁷ Stating that “the sham transaction and sham partnership approaches yield different results,”⁶⁸ the D.C. Circuit recognized that the distinction between finding that a transaction lacks overall economic substance and finding that a partnership used in the transaction should not be respected for tax purposes is something more than a mere academic distinction. Accordingly, the D.C. Circuit vacated the Tax Court decision and remanded the case

⁶² The parties initially formed Saba Partnership to carry out the transaction. However, after Brunswick ultimately sold more assets and realized more capital gains than originally expected, the parties formed a second partnership, Otrabanda *Investerings* Partnership, to generate additional offsetting capital losses. *Saba*, 273 F.3d at 1138. The IRS asserted deficiencies with respect to each partnership, and the two cases were consolidated for litigation.

⁶³ The capital losses generated by the transaction were the result of the application of the contingent installment sales rules of Temp. Treas. Reg. 15A.453-1, cited *supra*, note 49.

⁶⁴ 78 T.C.M. (CCH) at 719.

⁶⁵ *Id.* at 722.

⁶⁶ *Id.*

⁶⁷ The Government also filed a cross-appeal in the case with regard to the decision by the Tax Court not to consider whether the partnerships involved in the transaction were themselves valid partnerships for tax purposes. *Saba*, 273 F.3d at 1136.

⁶⁸ *Id.* at 1140.

to give Brunswick an opportunity to make the argument that the partnerships used in its transaction were valid and should be respected for tax purposes.⁶⁹

Boca Investerings

Although the Government generally has been successful in litigating the large capital losses claimed by taxpayers who engaged in the contingent installment sale transactions,⁷⁰ its record is not perfect. In *Boca Investerings Partnership v. United States*,⁷¹ American Home Products Corp. (“American Home Products”) realized capital gains of approximately \$600 million in 1990 from the sale of a subsidiary. In order to generate capital losses that would offset these otherwise taxable capital gains, American Home Products entered into a contingent installment sale transaction that was proposed by Merrill Lynch and was substantially similar to the transactions at issue in *ACM*, *Saba*, and *ASA*. Like the transactions involved in those cases, newly formed subsidiaries of Merrill Lynch and ABN, N.V. joined with a newly formed subsidiary of American Home Products to form a partnership (Boca Investerings). The partnership purchased and shortly thereafter sold floating-rate notes that generated capital losses⁷² that were allocated to American Home Products.

On audit, the IRS disallowed the capital losses claimed by American Home Products. In addition to challenging the overall economic substance of the transaction and the validity of the partnership for tax purposes, the IRS also claimed in the alternative that: the subsidiaries of ABN, N.V. made loans rather than capital contributions to the partnership; the individual purchase and sale of private placement notes by the partnership should be disregarded under the step transaction doctrine; the sale of the private placement notes by the partnership did not satisfy the statutory requirements for installment sale reporting under section 453; and the initial capital gain allocated to the foreign subsidiaries of ABN, N.V. should be reallocated to American Home Products in order to have substantial economic effect as required by section 704(b). American Home Products disputed the disallowance of the claimed capital losses and filed suit against the Government in the D.C. District Court.

The court rejected each of the arguments made by the Government in disallowing the capital losses, and ruled in favor of American Home Products. In determining whether the transaction in question should be respected under the economic substance doctrine, the court stated that the test in the D.C. Circuit requires a transaction to be respected under the doctrine unless it lacks both a valid non-tax business purpose and a reasonable possibility of profit.⁷³

⁶⁹ *Id.* at 1141.

⁷⁰ In August 2001, the IRS announced that it had reached a settlement with Merrill Lynch relating to the contingent installment sale transactions that included, *inter alia*, a substantial payment by Merrill Lynch to the IRS. *See infra*, note 146 and accompanying text.

⁷¹ 167 F. Supp. 2d 298 (D.D.C. 2001).

⁷² The capital losses generated by the transaction were the result of the application of the contingent installment sales rules of Temp. Treas. Reg. 15A.453-1, cited *supra*, note 49.

⁷³ *Id.* at 376-377 (citing *Horn v. Commissioner*, 968 F.2d 1229 (D.C. Cir. 1992)).

With respect to the transaction undertaken by American Home Products, the court found that the transaction had a valid non-tax business purpose and, therefore, satisfied the economic substance doctrine without regard to whether the transaction had a reasonable possibility of producing a profit.⁷⁴ Although the court determined that it did not need to consider the question of whether the transaction had a reasonable expectation of profitability, the court concluded that the non-tax business purpose of the transaction was, “namely to make investments that would generate profit.”⁷⁵ The Government has appealed the *Boca* case to the D.C. Circuit Court of Appeals, which is the court that heard the appeals in the *ASA* and *Saba* cases.

Salina Partnership case

In contrast to the contingent installment sale cases in which the taxpayers attempted to generate capital losses to offset taxable capital gains, another recent case involves a partnership transaction that purported to generate capital gains which would offset capital losses that otherwise were going to expire unused by the taxpayer. In *Salina Partnership LP v. Commissioner*,⁷⁶ FPL Group, Inc. (the holding company parent of Florida Power and Light Co.) realized capital losses of approximately \$580 million in 1991 from the sale of Colonial Penn Group, an insurance subsidiary of FPL. Although FPL was able to utilize some of the capital losses to offset other capital gains in 1991 and earlier years, FPL had to carry forward approximately \$310 million of the capital losses. In late 1992, two newly formed subsidiaries of ABN, N.V. formed a partnership (Salina Partnership LP) with a combined cash contribution of approximately \$75 million. On the day after its formation, Salina entered into a short sale of Treasury bills with a face value of \$350 million. Prior to the close of the short sale by Salina, FPL purchased a 98-percent interest in the partnership from one of the subsidiaries of ABN, N.V. Following the entry of FPL into the partnership, Salina closed the short sale. Based upon

⁷⁴ *Id.* at 377 (“Since satisfaction of either prong of the test is sufficient to demonstrate that a transaction has economic substance, the Court need not draw any conclusions regarding the second prong--whether, using an objective analysis, the transactions had a reasonable prospect of making a profit.”) In *dicta*, the court also did conclude that the transaction had a reasonable possibility of profit and, thus, satisfied the second element of the economic substance doctrine.

⁷⁵ *Id.* Although the *Boca* case involved a transaction that was very similar to the transactions in *ACM*, *Saba*, and *ASA*, some commentators have surmised that *Boca* can be factually distinguished from the other cases. See Christopher Kliefoth and William L. Goldman, “A Contingent Payment Installment Sale Upheld--Why Did This Transaction Pass Muster?” 96 J. Tax’n 114 (2002) (“The difference in the result reflected the difference in the way the transactions in *Boca* were implemented.”). However, other commentators have maintained that the holding in *Boca* hinged on the exclusion of evidence that would have favored the Government’s case. See Lee A. Sheppard, “Corporate Tax Shelters: Getting Away From The Script,” 93 Tax Notes 460 (Oct. 22, 2001) (“Evidence in the form of bank and taxpayer internal memorandums that were admitted in every other Merrill Lynch installment sale deal case was excluded in *Boca*.”).

⁷⁶ 80 T.C.M. (CCH) 686 (2000).

regulations in effect at the time, Salina reported a capital gain of approximately \$344 million from the short sale.⁷⁷ Salina allocated approximately \$337 million of its capital gain to FPL, and FPL used its distributive share of the capital gains to offset its capital losses from the earlier sale of Colonial Penn Group. FPL increased the basis in its Salina partnership interest to reflect its distributive share of capital gains.⁷⁸

On audit, the IRS disallowed the capital gains claimed by FPL on the grounds that the investment in Salina by FPL should be disregarded because it lacked economic substance and, alternatively, that Salina overstated the amount of capital gain that it realized on closing the short sale because it failed to treat its obligation to close the short sale (by delivering Treasury bills) as a liability under the partnership tax rules. With regard to economic substance, the Tax Court determined that “FPL’s investment in Salina provided a reasonable opportunity for FPL to earn profits independent of tax benefits.”⁷⁹ Accordingly, the Tax Court rejected the contention of the IRS that the investment in Salina by FPL should be disregarded because it lacked economic substance. The court then proceeded to the more technical argument made by the IRS that Salina overstated its capital gain under the partnership tax rules.⁸⁰ Concluding that Salina should have treated its obligation to close the short sale as a liability, the Tax Court determined that Salina did overstate its capital gain and, in turn, that FPL overstated its distributive share of the capital gain.

⁷⁷ Former Treas. Reg. sec. 1.708-1(b)(1)(iv). Based upon this regulation and its interaction with other partnership tax rules, Salina claimed that the entry of FPL into the partnership caused a deemed distribution and recontribution of the assets in the partnership, ultimately resulting in a capital gain when Salina closed the short sale and a built-in capital loss in FPL’s partnership interest that corresponded to its distributive share of the capital gain claimed by Salina.

⁷⁸ By generating capital gain, the transaction purportedly allowed FPL to offset the capital losses from the sale of Colonial Penn Group. If FPL had not offset the capital losses, the losses might have expired unused. Instead, by increasing the basis in its Salina partnership interest to reflect its distributive share of the capital gain claimed by Salina after closing the short sale, FPL created a built-in loss in its partnership interest that FPL could utilize indefinitely against future capital gains by selling some or all of its Salina partnership interest.

⁷⁹ *Salina*, 80 T.C.M. (CCH) at 695.

⁸⁰ Citing *ACM*, the court stated that, “[o]nly after we conclude that a transaction is not an economic sham do we review the tax consequences of the transaction under the Code.” *Salina*, 80 T.C.M. (CCH) at 694. The *Salina* case has been criticized for undertaking an inherently more imprecise economic substance analysis before first examining whether the transaction that produced the claimed tax benefits satisfied the technical tax rules. See Lee A. Sheppard, “*Economic Substance Abuse*,” 89 Tax Notes 1095 (Nov. 27, 2000) (“If the taxpayer’s transaction is not within the statute in the first place, the court never reaches the economic substance question. The *Salina* treatment [of the short sale obligation] was incorrect according to administrative interpretations of section 752. Judge Jacobs [the judge in the *Salina* case] need not have reached the economic substance question.”).

The Compaq and IES cases

Like *ACM* and the other contingent installment sales cases, the recent cases of *Compaq Computer Corp. v. Commissioner*⁸¹ and *IES Industries, Inc. v. United States*⁸² involved efforts by corporate taxpayers effectively to reduce the tax on large realized capital gains. In these cases, however, the tax benefits claimed by the taxpayers ultimately were sustained in litigation.

The *Compaq* and *IES* cases involved substantially similar cross-border “dividend-stripping” transactions, in which the taxpayer purchased the stock of a foreign corporation (in the form of American Depositary Receipts, or “ADRs”) immediately before the dividend record date, and then quickly sold the stock back to the original seller, ex-dividend. Because the ex-dividend price of the stock sold was lower than the cum-dividend price of the stock purchased, the transaction generated a capital loss for the taxpayer. The amount of the capital loss was roughly equal to the dividend amount. Although the dividend itself was includible in income, thus potentially offsetting the benefit of the capital loss, the dividend carried foreign tax credits, which significantly reduced the tax on the dividend income. At issue in the *Compaq* and *IES* cases was whether the transaction had sufficient economic substance and business purpose to be given its intended effect.⁸³

In the *Compaq* case, in July 1992 the taxpayer (Compaq) realized a capital gain of \$231.7 million⁸⁴ on the sale of a subsidiary. Twenty-First Securities Corporation, an investment firm, learned of this gain and approached Compaq to discuss strategies to “take advantage of” it.⁸⁵ On September 16, 1992, Twenty-First Securities executed a dividend-stripping transaction on Compaq’s behalf by: (1) purchasing 10 million Royal Dutch Petroleum Company ADRs (for \$887.6 million, the cum-dividend price) from another Twenty-First Securities client under special “next-day” settlement terms; and then (2) immediately reselling the same 10 million ADRs (for \$868.4 million, the ex-dividend price) back to the same client under the five-day settlement terms that generally apply on the New York Stock Exchange (“NYSE”).⁸⁶ The dividend record date for the Royal Dutch ADRs was September 18, 1992. Thus, under the special settlement terms, Compaq was the shareholder of record on the record date and was entitled to a gross dividend of \$22.5 million. Since this dividend was subject to Dutch

⁸¹ 277 F.3d 778 (5th Cir. 2001), *rev’g* 113 T.C. 214 (1999).

⁸² 253 F.3d 350 (8th Cir. 2001) *rev’g* 84 A.F.T.R.2d (RIA) 6445 (N.D. Iowa 1999).

⁸³ Section 901(k), enacted in 1997 after the *Compaq* and *IES* transactions, would disallow the foreign tax credits claimed in a similar transaction governed by present law.

⁸⁴ All figures in this discussion are approximated for ease of exposition.

⁸⁵ *Compaq*, 113 T.C. at 215.

⁸⁶ These transactions were executed in 23 separate pairs of purchase and resale trades, all of which took place on the floor of the NYSE between 2:58 p.m. and 4:00 p.m. on September 16, 1992.

withholding tax at a rate of 15 percent (\$3.4 million) under the U.S.-Netherlands income tax treaty, Compaq received a net dividend payment of \$19.2 million.

Compaq claimed a capital loss of \$20.7 million as a result of the purchase and resale of the Royal Dutch ADRs. Compaq also reported \$22.5 million of dividend income but claimed a foreign tax credit for the \$3.4 million of Dutch taxes withheld. Compaq also incurred fees to Twenty-First Securities and other transaction costs totaling \$1.5 million. The tax benefit to Compaq of the foreign tax credit exceeded the additional U.S. tax payable on the dividend income (and indeed exceeded the sum of that tax and Compaq's transaction costs).

The Tax Court disregarded the transaction and thus disallowed the foreign tax credits and the capital loss claimed by Compaq, finding that the transaction was designed "to yield a specific result and to eliminate all economic risks and influences from outside market forces."⁸⁷ Specifically, the court determined that Compaq "had no reasonable possibility of profit from the ADR transaction without the anticipated Federal income tax consequences" and "had no business purpose for the purchase and sale of Royal Dutch ADRs apart from obtaining a Federal income tax benefit in the form of a foreign tax credit while offsetting the previously recognized capital gain."⁸⁸ The Tax Court computed Compaq's net cash flow on the transaction and found that, leaving aside the effect of the foreign tax credit, Compaq lost \$1.5 million.⁸⁹ Thus, in the Tax Court's view, Compaq had no expectation of economic profit apart from the intended tax consequences of the transaction. The court also found that, although the trades took place on the floor of the NYSE, they were highly orchestrated and very quickly executed, removing any meaningful risk of price fluctuations or "breaking up" of the trades by other traders on the floor. Finally, the court evaluated Compaq's conduct in deciding whether to undertake the transaction and found that Compaq's evaluation of the deal was "less than businesslike," since the company undertook no significant analysis of the deal apart from the expected tax consequences.

The Fifth Circuit reversed the Tax Court and held that Compaq was entitled to the foreign tax credits and capital loss claimed in the transaction. The Fifth Circuit found that the Tax Court's cash-flow calculation resulted in a misapplication of the economic substance and business purpose doctrines, since that calculation treated the Dutch withholding tax as a cost of the transaction but omitted the U.S. foreign tax credit associated with that tax. In the Fifth Circuit's view, this calculation was "half pre-tax, half after-tax" and "stack[ed] the deck against finding the transaction profitable."⁹⁰ Thus, according to the Fifth Circuit, foreign taxes are to be treated no differently from U.S. taxes in assessing the pre-tax profitability of a transaction for purposes of applying the economic substance and business purpose doctrines. Applying this

⁸⁷ *Compaq*, 113 T.C. at 219-20.

⁸⁸ *Id.*

⁸⁹ \$868.4 million proceeds from ADR sales - \$887.6 million cost of ADR purchases + \$22.5 million gross dividend - \$3.4 million Dutch withholding tax - \$1.5 million transaction costs = a loss of \$1.5 million (totals do not sum precisely, due to rounding).

⁹⁰ *Compaq*, 277 F.3d at 782, 785.

approach, the Fifth Circuit determined that Compaq had a pre-tax economic profit of \$1.9 million on the transaction,⁹¹ which the court found sufficient to satisfy the economic substance and business purpose tests.⁹² The Fifth Circuit's conclusion as to economic substance was further bolstered by its finding that the transaction did involve substantial risk, since it occurred on the floor of the NYSE, an environment that no one can fully control. As to business purpose, the Fifth Circuit concluded that where sufficient pre-tax profit can be shown, evidence of significant tax motivation should not invalidate the transaction.⁹³

The IES dividend-stripping transaction was substantially similar to Compaq's. As in the *Compaq* case, the transaction was promoted and executed by Twenty-First Securities, and the essential features of the two transactions were the same.⁹⁴ Since IES sought to use part of the capital losses generated in the transaction as capital loss carrybacks to offset capital gains realized in prior years, it filed refund claims as to the carrybacks, which were litigated in a U.S. District Court.

The District Court, in a brief order granting summary judgment in the Government's favor, disregarded the transaction under the sham transaction doctrine, finding that the IES transaction did not change IES's economic position, aside from the transfer of the foreign tax credit to IES, and that the transaction was purely tax-motivated. The District Court's order provided little explanation of its analysis.

⁹¹ Starting with the negative \$1.5 million cash flow computed by the Tax Court, adding back the \$3.4 million of Dutch withholding tax that was subtracted in that calculation yields a positive cash flow of \$1.9 million.

⁹² The court also cited *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) -- which held that an employer's discharge of an employee's federal tax liability resulted in taxable income to the employee -- in support of the court's view that the Dutch taxes withheld on Compaq's behalf should be treated as positive, not negative, cash flows to Compaq in the pre-tax profit analysis.

⁹³ Neither court in the *Compaq* case directly addressed how, if at all, to factor the market pricing of tax attributes into an economic substance and business purpose analysis. In other words, focusing on the deal between Compaq and its counterparty, Compaq effectively purchased a net dividend of \$19.2 million and paid the counterparty \$19.2 million for this dividend. But this dividend also carried a U.S. foreign tax credit of \$3.4 million, for which Compaq evidently paid nothing. In other words, the benefit of this transaction to Compaq arose in part from an *economic* arbitrage relating to a U.S. tax attribute, but neither court evaluated the case in this light. Some may argue that further analysis could be undertaken in the future to determine how the judicial doctrines might be refined to account for transactions driven by this sort of combination of anticipated benefits.

⁹⁴ The main potentially salient difference is that the IES transaction involved after-hours trades off the floor of any public exchange, thus arguably exposing IES to even less risk than Compaq faced in its transaction, which was executed entirely on the floor of the NYSE.

The Eighth Circuit reversed the District Court, finding that IES had a reasonable expectation of pre-tax profit and thus holding that the transaction possessed sufficient economic substance and business purpose. The Eighth Circuit concluded that the calculation of pre-tax profit must include the entire gross dividend as a positive cash flow, unreduced by foreign withholding tax. Thus, the Eighth Circuit's analysis of pre-tax profit was essentially similar to the Fifth Circuit's -- indeed, the Fifth Circuit patterned its analysis in *Compaq* on that of the Eighth Circuit in *IES*. The Eighth Circuit did not address the lack of any meaningful market risk to IES on the trades.

Special application: leasing transactions

A line of authorities has developed addressing economic substance (and, as discussed below, business purpose) specifically in connection with leasing transactions. The analysis with respect to leasing transactions (particularly leveraged leases and sale-leaseback transactions) focuses on who should be entitled to the benefits of tax ownership such as depreciation deductions.

The determination of tax ownership sometimes overlaps with the determinations of whether the transactions have economic substance and business purpose. The Supreme Court articulated the standard as follows: "where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."⁹⁵ The Fourth Circuit has interpreted *Frank Lyon* to require a two-prong analysis with respect to sale-leaseback transactions: namely, the court "must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of profit exists."⁹⁶ In analyzing the economic substance of a leasing transaction, the Tax Court found that economic substance was not present where the discounted present value of the future rental income and sale proceeds would be less than the present value of the amount expended by the investors.⁹⁷

⁹⁵ *Frank Lyon Co. v. Commissioner*, 435 U.S. 561, 583-84 (1978).

⁹⁶ *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985).

⁹⁷ *Hilton v. Commissioner*, 74 T.C. 305, 353 n.23 (1980), *aff'd* 671 F.2d 316, 317 (9th Cir. 1982). The Tax Court arrived at the present value using a six-percent discount rate found in the estate tax regulations for purposes of making actuarial valuations. Although affirmed on appeal, the Ninth Circuit observed that the six-percent rate was illustrative only and that no suggestion of a minimum required rate of return is intended. *See also, Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). In *Estate of Franklin*, property was overvalued when acquired by the lessor, and the lessor had no reasonable expectation of a residual value, so the court held that the lessor had no depreciable investment in the property and the nonrecourse debt was not true debt.

In addition to its application by the courts, economic substance is a component of the guidelines that were adopted in 1975 by the IRS for advance ruling purposes with respect to determining whether certain transactions purporting to be leases of property are, in fact, leases for Federal income tax purposes.⁹⁸ The guidelines require that the lessor represent and demonstrate that it expects to receive a profit, apart from the value of or benefits obtained from tax deductions, allowances, credits, and other tax attributes arising from such transaction.

Business purpose doctrine

As previously discussed, another doctrine that overlays and is often considered together with (if not part and parcel of) the sham transaction and economic substance doctrines is the business purpose doctrine. In its common application, the courts use business purpose (in combination with economic substance, as discussed above) as part of a two-prong test for determining whether a transaction should be disregarded for tax purposes: (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction lacks economic substance.⁹⁹ In essence, a transaction will only be respected for tax purposes if it has “economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached.”¹⁰⁰

The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose.¹⁰¹ Finally, where appropriate, the court may bifurcate a transaction in which independent activities with non-tax objectives have been combined with an unrelated transaction having only tax-avoidance objectives in order to establish a business purpose for the overall transaction.¹⁰² Thus, a taxpayer cannot utilize an unrelated business objective to hide the lack of business purpose with respect to the particular tax-motivated activities.

Substance over form doctrine

The concept of the substance over form doctrine is that the tax results of an arrangement are better determined based on the underlying substance rather than an evaluation of the mere formal steps by which the arrangement was undertaken. Under this doctrine, two transactions

⁹⁸ Rev. Proc. 75-21, 1975-1 C.B. 715.

⁹⁹ *Rice's Toyota World*, 752 F.2d at 91.

¹⁰⁰ *Frank Lyon Co.*, 435 U.S. at 561. Cf. *Esmark v. Commissioner*, 90 T.C. 171, 198 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989) (not disregarding steps of a transaction where, for example, a tender offer was not a “‘mere device’ having no business purpose”).

¹⁰¹ See e.g., *Rice's Toyota World*, 752 F.2d at 89; *ACM*, 157 F.3d at 231; *Peerless Indus. v. Commissioner*, 1994-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

¹⁰² *ACM*, 157 F.3d at 256 n.48.

that achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps. The Supreme Court has found that a “given result at the end of a straight path is not made a different result because reached by following a devious path.”¹⁰³ However, many areas of income tax law are very formalistic and, therefore, it is often difficult for taxpayers and the courts to determine whether application of the doctrine is appropriate.

The IRS generally has the ability to recharacterize a transaction according to its underlying substance. Taxpayers, however, are usually bound to abide by their chosen legal form.¹⁰⁴ In *National Alfalfa Dehydrating & Mill & Co.*, the Supreme Court ruled as follows:

This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, [citations omitted], and may not enjoy the benefit of some other route he might have chosen to follow but did not.¹⁰⁵

The IRS has published administrative guidance that applies the substance over form doctrine in a variety of contexts.¹⁰⁶ Taxpayers and tax practitioners apply these pronouncements, as well as certain favorable court cases, as an exception to the general rule that taxpayers are bound by their chosen form.

Step transaction doctrine

An extension of the substance over form doctrine is the step transaction doctrine. The step transaction doctrine “treats a series of formally separate ‘steps’ as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result.”¹⁰⁷ The courts have generally developed three methods of testing whether to invoke the step transaction doctrine: (1) the end result test, (2) the interdependence test, and (3) the binding commitment test.

¹⁰³ *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

¹⁰⁴ *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967); *In the matter of: Insilco Corporation v. United States*, 53 F.3d 95 (5th Cir. 1995).

¹⁰⁵ *Commissioner v. National Alfalfa Dehydrating & Mill Co.*, 417 U.S. 134, 149 (1974). See also *Higgins v. Smith*, 308 U.S. 473, 477 (1940).

¹⁰⁶ See Rev. Rul. 78-397, 1978-2 C.B. 150, Rev. Rul. 83-142, 1983-2 C.B. 68, and Rev. Rul. 80-154, 1980-1 C.B. 68 (disregarding circular cash flows in transactions); Rev. Rul. 73-427, 1973-2 C.B. 301 (viewing a reverse subsidiary merger as a taxable stock purchase); Rev. Rul. 67-274, 1967-2 C.B. 141 (treating “B” reorganization followed by liquidation of acquired corporation as a “C” reorganization); Rev. Rul. 68-602, 1968-2 C.B. 135 (not respecting contribution of debt from a creditor-shareholder to a debtor-subsidiary for purposes of determining whether the subsidiary is eligible for tax-free liquidation).

¹⁰⁷ *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987).

The end result test is the broadest of the three articulations. The end result test examines whether it is apparent that each of a series of steps are undertaken for the purpose of achieving the ultimate result.¹⁰⁸ The interdependence test attempts to prove that each of the steps were so interdependent that the completion of an individual step would have been meaningless without the completion of the remaining steps. The binding commitment test is the narrowest of the three articulations and looks to whether, at the time the first step is entered into, there is a legally binding commitment to complete the remaining steps.¹⁰⁹

In determining whether to invoke the step transaction doctrine, the courts have looked to two primary factors: (1) the intent of the taxpayer,¹¹⁰ and (2) the temporal proximity of the separate steps. If a taxpayer can provide evidence that at the time the first of a series of steps was undertaken, there was no plan or intention to effectuate the other steps, then the transactions should not be stepped together. An important factor that supports a taxpayer's lack of intent is found where subsequent steps are prompted by external, unexpected events that are beyond the taxpayer's control. If there is no legally binding commitment to engage in subsequent steps after undertaking the initial transaction, the span of time between the events is an important measure in determining whether the transactions should be stepped together. A significant lapse of time between a series of transactions should prevent the application of the step transaction doctrine.¹¹¹

The step transaction doctrine may not be invoked in all cases, irrespective of the taxpayer's intent or the temporal relationship of the separate steps. Aside from a case involving a legally binding agreement,¹¹² if each of a series of steps has independent economic significance, the transactions should not be stepped together.¹¹³ Also, the courts have not permitted the application of the step transaction doctrine if its application would create steps that never actually occurred.¹¹⁴ This limitation is sometimes viewed as prohibiting the use of the step transaction doctrine where the alternative transaction has at least the same number of steps.¹¹⁵

¹⁰⁸ *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969).

¹⁰⁹ *Commissioner v. Gordon*, 391 U.S. 83, 96 (1968).

¹¹⁰ *McDonalds Restaurants of Ill. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

¹¹¹ *Cal-Maine Foods, Inc. v. Commissioner*, 93 T.C. 181 (1989) (by implication); Martin D. Ginsburg et al., *Mergers, Acquisitions, and Buyouts*, para. 608.2.2 (Apr. 1999 edition).

¹¹² *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995).

¹¹³ *Reef Corporation v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); Rev. Rul. 79-250, 1979-2 C.B. 156, *modified* by Rev. Rul. 96-29, 1996-1 C.B. 50.

¹¹⁴ *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989); *Walt Disney, Inc. v. Commissioner*, 97 T.C. 221 (1991); *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973).

¹¹⁵ *West Coast Marketing Corporation v. Commissioner*, 46 T.C. 32 (1966); Rev. Rul. 70-140, 1970-1 C.B. 73.

3. Regulatory and administrative guidance

In recent years, the Treasury Department and IRS have issued regulatory and administrative guidance in connection with tax shelters. This guidance focuses primarily on requiring disclosure of transactions that may be considered potentially abusive, though it also includes notices that identify specific transactions in which the IRS will disallow the purported tax benefits. The IRS also has implemented certain organizational changes designed to improve the agency's collection, utilization, and dissemination of information regarding tax shelters.

Specifically, in March 2000, the Treasury Department and IRS issued temporary and proposed regulations, along with other administrative guidance, relating to tax shelters. The regulations establish certain disclosure obligations of corporate taxpayers that participate in any "reportable transaction."¹¹⁶ The regulations also describe the registration requirements of organizers who promote confidential corporate tax shelters under section 6111(d)(1),¹¹⁷ as well as the requirement under section 6112 that organizers of potentially abusive tax shelters maintain a list identifying each person who was sold an interest in such shelter.¹¹⁸ The administrative guidance included a description of the functions of the new Office of Tax Shelter Analysis,¹¹⁹ as well as an IRS Notice that identified several transactions ("listed transactions") that must be disclosed by corporate taxpayers and registered by promoters.¹²⁰ These items are described in greater detail below.

Disclosure of reportable transactions by corporate participants

The temporary and proposed regulations under section 6011 require corporate taxpayers to disclose with their tax return certain information for each "reportable transaction" in which the corporate taxpayer participates. The disclosure statement is filed with the taxpayer's corporate income tax return for each year that the corporation's tax liability is affected by the reportable transaction; the taxpayer also must provide a copy of the disclosure statement to the Office of Tax Shelter Analysis in Washington, D.C. for the first taxable year for which the transaction is disclosed on the taxpayer's Federal income tax return.¹²¹

¹¹⁶ Temp. Treas. Reg. sec. 1.6011-4T (as amended by T.D. 8896, 2000-36 I.R.B. 258, and T.D. 8961, 2001-35 I.R.B. 194).

¹¹⁷ Temp. Treas. Reg. sec. 301.6111-2T (as amended by T.D. 8896, 2000-36 I.R.B. 258, and T.D. 8961, 2001-35 I.R.B. 194).

¹¹⁸ Temp. Treas. Reg. sec. 301.6112-1T (as amended by T.D. 8896, 2000-36 I.R.B. 258).

¹¹⁹ I.R.S. Announcement 2000-12, 2000-1 C.B. 835.

¹²⁰ I.R.S. Notice 2000-15, 2000-1 C.B. 826, superseded by I.R.S. Notice 2001-51, 2001-34 I.R.B. 190.

¹²¹ Temp. Treas. Reg. sec. 1.6011-4T(d)(1).

Reportable transactions fall into two categories. The first category covers any transaction that is the same as (or substantially similar to) one of the specified types of tax avoidance transactions that the IRS has identified by published guidance as a “listed transaction” and that is expected to reduce the taxpayer’s Federal income tax liability by more than \$1 million in any single taxable year or more than \$2 million in any combination of years.¹²²

The second category of reportable transactions covers transactions that are expected to reduce a taxpayer’s Federal income tax liability by more than \$5 million in any single year or \$10 million in any combination of years and that have at least two of the following characteristics: (1) the taxpayer has participated in the transaction under conditions of confidentiality; (2) the taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained (such as rescission rights, a full or partial refund of fees, fees that are contingent on a taxpayer’s realization of tax benefits, or a tax indemnity or similar agreement); (3) the promoters of the transaction have received or are expected to receive fees or other consideration with an aggregate value in excess of \$100,000, and such fees are contingent on the taxpayer’s participation; (4) a book/tax difference in excess of \$5 million in any taxable year; or (5) the transaction involves a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such as a tax-exempt entity or foreign person), and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured to provide the taxpayer with more favorable Federal income tax treatment than it could have obtained without the participation of such person.¹²³

There is no penalty for failing to disclose a reportable transaction. However, such a failure may jeopardize the taxpayer’s ability to claim that any understatement attributable to the arrangement is due to reasonable cause, and that the taxpayer acted in good faith.¹²⁴

A taxpayer can avoid disclosure with respect to the second category of reportable transactions if (1) the taxpayer has participated in the transaction in the ordinary course of the taxpayer’s trade or business in a form consistent with customary commercial practice and would have entered into the transaction on substantially the same terms irrespective of the expected Federal income tax benefits; (2) the taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice and the taxpayer reasonably determines that there is a generally accepted understanding that the expected Federal income tax benefits from the transaction are allowable under the Code; (3) the taxpayer reasonably determines that there is no reasonable basis under Federal tax law for denial of any

¹²² Temp. Treas. Reg. sec. 1.6011-4T(b)(2) and -(b)(4)(i).

¹²³ Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(i)(A)-(E).

¹²⁴ As described below, section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable cause for the underpayment and that the taxpayer acted in good faith.

significant portion of the expected tax benefits from the transaction; or (4) the transaction is identified in published guidance as excepted from disclosure.¹²⁵

Registration and list maintenance requirements of tax shelter promoters

Registration of tax shelters (sec. 6111)

Section 6111 requires an organizer of a tax shelter to register the tax shelter with the Secretary not later than the day on which the shelter is first offered for sale. A tax shelter for this purpose means any investment with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment that the tax shelter ratio¹²⁶ for any investor as of the close of any of the first five years ending after the date on which such investment is offered for sale may be greater than two to one and which is: (1) required to be registered under Federal or State securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State securities agency, or (3) a substantial investment (greater than \$250,000 and at least five investors).¹²⁷

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of Federal income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the tax shelter promoter may receive fees in excess of \$100,000 in the aggregate.¹²⁸

The temporary and proposed regulations under section 6111 describe what constitutes a “significant purpose of avoiding or evading Federal income tax.” Specifically, this standard is satisfied if the transaction: (1) is the same as or substantially similar to one of the specified types of transactions that the IRS has identified in published guidance as a “listed transaction,”¹²⁹ or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.¹³⁰ With respect to the second category of transactions, an exception is provided to the extent that the promoter reasonably determines that the potential participant is expected to

¹²⁵ Temp. Treas. Reg. sec. 1.6011-4T(b)(3)(ii)(A)-(E).

¹²⁶ The tax shelter ratio is, with respect to any year, the ratio that the aggregate amount of the deductions and 350 percent of the credits, which are represented to be potentially allowable to any investor, bears to the investment base (money plus basis of assets contributed) as of the close of the tax year.

¹²⁷ Sec. 6111(c).

¹²⁸ Sec. 6111(d).

¹²⁹ Temp. Treas. Reg. sec. 301.6111-2T(b)(2).

¹³⁰ Temp. Treas. Reg. sec. 301.6111-2T(b)(3).

participate in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and that there is a generally accepted understanding that the expected Federal income tax benefits from the transaction are allowable under the Code for substantially similar transactions.¹³¹ Exceptions are also provided for transactions that (1) have been publicly identified by the Treasury Department as not requiring registration, or (2) a promoter reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits from the transaction.¹³²

An arrangement is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement to limit the disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows, or has reason to know that a party other than the potential participant claims that the transaction (or any aspect of it) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use.¹³³

Tax shelter promoter investor lists (sec. 6112)

Section 6112 requires promoters to maintain (for a period of seven years) a list identifying each person who was sold an interest in any tax shelter with respect to which registration was required under section 6111 (even though the particular party may not have been subject to confidentiality restrictions). The temporary and proposed regulations under section 6112 provide that, in addition to the name, tax shelter identification number and other identifying information the promoter must include detailed information about the tax shelter (including details of the shelter and the expected tax benefits, as well as copies of any additional written material given to any participant or advisor).¹³⁴ Moreover, the requirements under section 6111(d) that require confidentiality and aggregate fees in excess of \$100,000 do not apply for purposes of defining the types of corporate tax shelters for which a list must be maintained (though a limited exception is provided for certain shelters if the total fees are less than \$25,000 or if the expected reduction in tax liabilities for any single year is less than \$1 million for corporations or \$250,000 for non-corporate taxpayers).¹³⁵

¹³¹ Treas. Reg. sec. 301.6111-2T(b)(3)(i) and -(ii).

¹³² Temp. Treas. Reg. sec. 301.6111-2T(b)(4)(i) and -(ii).

¹³³ The regulations provide that the determination of whether an arrangement is offered under conditions of confidentiality is based on all the facts and circumstances surrounding the offer. If an offeree's disclosure of the structure or tax aspects of the transaction are limited in any way by an express or implied understanding or agreement with or for the benefit of a tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Treas. Reg. sec. 301.6111-2T(c)(1).

¹³⁴ See Temp. Treas. Reg. sec. 301.6112-1T Q&A 17.

¹³⁵ See Temp. Treas. Reg. sec. 301-6112-1T Q&A 8.

Office of Tax Shelter Analysis

The IRS Office of Tax Shelter Analysis (“OTSA”), formed in February 2000, is part of the IRS Large and Mid-Size Business Division and serves as the focal point for tax shelter compliance initiatives, including information relating to tax shelters affecting taxpayers other than those served by the IRS Large and Mid-Size Business Division.

The Treasury Department and IRS have announced¹³⁶ that the responsibilities of the OTSA include: (1) reviewing all disclosures by promoters and taxpayers under the tax shelter disclosure regulations, (2) identifying taxpayers that have participated in such transactions, to assist in evaluating the tax treatment of cutting edge tax-structured transactions to identify improper tax shelters, and (3) providing a better assessment of the overall extent of tax shelter activity by taxpayers. In addition, the OTSA is responsible for planning, coordinating and providing assistance to field personnel on tax shelter issues. OTSA also is responsible for the review of tax shelter transactions that come to the attention of the IRS in other ways, including transactions examined by field personnel and those that are disclosed to the IRS by taxpayers, practitioners, and other members of the public.

As part of its ongoing effort to obtain more information regarding tax shelters, the OTSA has implemented procedures to enable persons to submit information relating to tax shelter transactions and activities on an anonymous basis. In addition, on December 21, 2001, the IRS announced a temporary (120-day) disclosure initiative that provides taxpayers an opportunity to voluntarily disclose their tax treatment of tax shelters and other questionable transactions for which the imposition of an accuracy-related penalty may be appropriate if there is an underpayment of tax.¹³⁷ In general, the IRS will waive certain accuracy-related penalties if a taxpayer voluntarily discloses questionable transactions in accordance with the initiative.

Listed transactions

As part of the IRS’s effort to obtain information as early as possible on tax shelter transactions, the regulations require promoter registration and taxpayer disclosure for certain “listed transactions.” A listed transaction is a transaction the Treasury Department and IRS have identified as having a tax avoidance purpose and that the tax benefits are subject to disallowance under existing law. When the Treasury Department and the IRS determine a transaction has a tax avoidance purpose, a notice is issued informing taxpayers of the details of such transaction.¹³⁸ The list is supplemented from time to time, when other such tax avoidance transactions are identified.

¹³⁶ I.R.S. Announcement 2000-12, 2000-1 C.B. 835.

¹³⁷ I.R.S. Announcement 2002-2, 2002-2 I.R.B. 304.

¹³⁸ See I.R.S. Notice 2002-21, I.R.B. 2002-14 (forthcoming April 8, 2002), *reprinted in* BNA Daily Tax Report, No. 53 at L-1 (March 19, 2002), for the most recent example of a transaction that has been identified as a listed transaction for purposes of the taxpayer disclosure, promoter registration, and list maintenance requirements. I.R.S. Notice 2001-51, 2001-34 I.R.B. 190, contains the most recent comprehensive list of “listed transactions” as of August 20, 2001.

B. Penalties and Sanctions Applicable to Tax Shelters

1. Penalties

Taxpayer penalties relating to tax shelters

Accuracy-related penalty (sec. 6662)

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or \$5,000 (\$10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.

In determining whether a substantial understatement exists, the amount of the understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. In no event does a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation.

Special rules apply with respect to tax shelters. For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. For these purposes, a tax shelter is defined as (1) a partnership or other entity, (2) an investment plan or arrangement, or (3) any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.¹³⁹

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was “reasonable cause” for the underpayment and that the taxpayer acted in good faith.¹⁴⁰ The relevant regulations provide that reasonable cause exists where the taxpayer “reasonably relies in good faith on an opinion based on a professional tax advisor’s analysis of the pertinent facts and authorities [that] . . . unambiguously

¹³⁹ Sec. 6662(d)(2)(C)(iii).

¹⁴⁰ Sec. 6664(c).

concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.”¹⁴¹

Fraud penalty (sec. 6663)

The accuracy-related penalty under section 6662 discussed above does not apply to any underpayment of tax that is attributable to fraud. Rather, a penalty under section 6663 equal to 75 percent of the understatement may be imposed. The IRS must establish by clear and convincing evidence that an understatement of tax exists and that an understatement is attributable to fraud. The courts have defined fraud to mean an intentional wrongdoing on the part of a taxpayer motivated by a specific purpose to evade a tax known or believed to be owing.¹⁴²

Non-taxpayer penalties

Understatement of taxpayer’s liability by income tax preparer (sec. 6694)

Section 6694 imposes a penalty on an income tax preparer for any understatement of tax liability on a tax return due to a position for which there was not a realistic possibility of success of being sustained on its merits, but only if (1) the return preparer knew (or reasonably should have known) of the position, and (2) the position was not adequately disclosed on the return or was frivolous.

An “income tax preparer” means any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund.¹⁴³

The penalty is \$250 with respect to each return, unless the preparer establishes that there was reasonable cause for the understatement and the preparer acted in good faith. The penalty amount is increased to \$1,000 if any part of the understatement is due to the preparer’s willful conduct, or reckless or intentional disregard of the rules and regulations.

¹⁴¹ Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c). Although rare, from time to time accuracy related penalties have been asserted in the context of tax shelters generally. See, e.g., *Sheldon v. Commissioner*, 94 T.C. 738, 769-70 (1990). In the corporate context specifically, see, e.g., *Compaq Computer Corp. v. Commissioner*, 113 T.C. 214 (1999), rev’d 277 F.3d 778 (5th Cir. 2001); *Leema Enterprises v. Commissioner*, 77 T.C.M. (CCH) 1261 (1999)). Because of the lack of clarity of the various economic substance and business purpose doctrines, however, courts are often reluctant to impose penalties in corporate tax shelter cases. See, e.g., *Peerless Indus. v. United States*, 94-1 U.S.T.C. (CCH) para. 50,043 (E.D. Pa. 1994).

¹⁴² *Stoltzfus v. United States*, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied, 393 U.S. 1020 (1969); *Powell v. Granquist*, 252 F.2d 56, 60 (9th Cir. 1958); *Webb v. Commissioner*, 394 F.2d 366, 377 (5th Cir. 1968); *Jenkins v. United States*, 313 F.2d 624 (5th Cir. 1963).

¹⁴³ Sec. 7701(a)(36)(A).

Penalties with respect to the preparation of income tax returns for others (sec. 6695)

Section 6695 imposes a penalty on any income tax return preparer who, in connection with the preparation of an income tax return, fails to: (1) furnish the taxpayer with a completed copy of the tax return; (2) sign the tax return (if required to do so by regulations); (3) furnish the proper identification number with respect to the tax return; (4) retain a copy of the completed return or a list (with names and taxpayer identification numbers) of the taxpayers for whom a return was prepared; or (5) comply with certain due diligence requirements in determining a taxpayer's eligibility for the earned income credit. Section 6695 also prohibits an income tax preparer from endorsing or otherwise negotiating a refund check that is issued to the taxpayer. In most cases, the penalty is \$50 for each failure, with a maximum penalty of \$25,000 per category. The failure to comply with the due diligence requirements in determining eligibility for the earned income credit carries a \$100 penalty for each failure.

Promoting abusive tax shelters (sec. 6700)

Section 6700 imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualifying false or fraudulent statement or a gross valuation overstatement. A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200 percent of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty equals \$1,000 (or, if the person establishes that it is less, 100 percent of the gross income derived or to be derived by the person from such activity). In calculating the amount of the penalty, the organizing of an entity, plan or arrangement and the sale of each interest in an entity, plan, or arrangement constitute separate activities. A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

Aiding and abetting understatement of tax liability (sec. 6701)

Section 6701 imposes a penalty on any person who (1) aids, assists, procures, or advises with respect to the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) knows (or has reason to believe) that the document will be used in connection with any material matter arising under the internal revenue laws, and (3) knows that the document would result in an understatement of another person's tax liability. The concept of

aiding or abetting requires “direct involvement” in the preparation or presentation of a tax return or other tax-related document.¹⁴⁴

Several definitions and special rules apply. The penalty applies to a person who orders (or otherwise causes) a subordinate to do an act, as well as a person who knows of, and does not attempt to prevent, participation by a subordinate in an act. A subordinate means any other person over whose activities the person subject to the penalty has direction, supervision, or control. The penalty applies whether or not the understatement is with the knowledge or consent of the persons responsible for the return or other document. A person furnishing typing, reproducing, or other mechanical assistance is not subject to the penalty.

The penalty for aiding and abetting with respect to an individual’s tax liability is \$1,000; the penalty is \$10,000 if the aiding and abetting is with respect to a corporation’s tax liability. A person can only be subject to this penalty once with respect to a particular taxpayer per period. Courts have held that there is no statute of limitations for purposes of applying this penalty.¹⁴⁵

Coordination rules apply such that a person who is subject to the aiding and abetting penalty is not also subject to the return preparer penalty (sec. 6694) or the promoter penalty (sec. 6700).

Failure to register tax shelters (section 6707)

Under section 6707, the penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of one percent of the aggregate amount invested in the shelter or \$500. However, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of \$10,000 or 50 percent of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75 percent of the applicable fees.

Section 6707 also imposes (1) a \$100 penalty on the promoter for each failure to furnish the investor with the required tax shelter identification number, and (2) a \$250 penalty on the investor for each failure to include the tax shelter identification number on a return.

In August 2001, the IRS announced that it had reached an agreement with Merrill Lynch resolving issues relating to tax shelter penalties under section 6707 (as well as sections 6700, 6701, and 6708) with respect to the contingent installment sale note transactions previously discussed.¹⁴⁶

¹⁴⁴ See Staff of the Joint Committee On Taxation, 97th Cong., *General Explanation to the Tax Equity and Fiscal Responsibility Act of 1982*, 220.

¹⁴⁵ *Mullikin v. United States*, 952 F.2d 920, 922-929 (6th Cir. 1991); see also *Kraye v. United States*, 93-1 U.S.T.C. (CCH) para. 50,047 (D.N.M. 1992).

¹⁴⁶ IRS News Release (IR-2001-74), August 29, 2001. Under the terms of the agreement, Merrill Lynch neither admitted nor denied that any contingent installment note transaction was

Failure to maintain lists of investors in potentially abusive tax shelters (section 6708)

Under section 6708, the penalty for failing to maintain the list required under section 6112 is \$50 for each name omitted from the list (with a maximum penalty of \$100,000 per year).

2. Injunctive actions

Action to enjoin income tax return preparers (sec. 7407)

Under section 7407, the Secretary may bring a civil action in district court to enjoin a tax return preparer from further engaging in conduct (1) described in section 6694 (the understatement of tax liability by a return preparer penalty, discussed above) or section 6695 (other assessable penalties with respect to the preparation of income tax returns, also discussed above), (2) misrepresenting his eligibility to practice or his experience or education, (3) guaranteeing the payment of any tax refund or allowance of any tax credit, or (4) engaging in any other fraudulent or deceptive conduct which substantially interferes with the proper administration of the Internal Revenue laws. For repeat offenses, the court may enjoin the person from acting as an income tax preparer.

Action to enjoin promoters of abusive tax shelters (sec. 7408)

Under section 7408, the Secretary may bring a civil action in district court to enjoin a person from further engaging in conduct subject to penalty under section 6700 (the penalty for promoting abusive tax shelters, discussed above) or section 6701 (the penalties for aiding and abetting the understatement of tax liability, also discussed above). Consequently, statements incidental to the operation of an abusive tax shelter, in addition to statements made in the organization or sale of an abusive tax shelter, are subject to injunction. These actions may be brought in the United States District Court for the district in which the promoter resides, has his principal place of business, or has engaged in the conduct subject to the penalty. If a citizen or resident of the United States does not reside in or have a principal place of business in any U.S. judicial district, such citizen or resident is treated as a resident of the District of Columbia.

A court may grant injunctive relief against any person if it finds (1) that the person has engaged in any conduct subject to the penalty, and (2) that injunctive relief is appropriate to prevent recurrence of such conduct.¹⁴⁷ The IRS does not need to assess or collect the penalty

required to be registered, though Merrill Lynch agreed to make a substantial payment to the IRS. For a detailed discussion of cases involving the contingent installment note transaction, *see supra* notes 43-75 and accompanying text.

¹⁴⁷ In addition to the specific injunction actions under sections 7407 and 7408, under section 7402(a), the United States is empowered to seek, and the United States District Court to grant, such decrees or orders, and processes (including injunctions) as may be necessary to enforce the internal revenue laws. The court also has full authority to act under its general equity jurisdiction and possesses the great latitude inherent in equity jurisdiction to fashion appropriate equitable relief. For example, a court could enjoin particular conduct or enjoin all conduct subject to the penalty. In addition, the court could enjoin any action tending to impede the

prior to proceeding with an injunction.¹⁴⁸ In addition, case law has indicated that traditional equity factors such as irreparable injury and likelihood of success on the merits need not be considered, provided that the Government has satisfied the statutory requirements.¹⁴⁹

proper administration of the tax law or any action that violates criminal statutes. *See e.g., United States v. Landsberger*, 692 F.2d 501 (8th Cir. 1982).

¹⁴⁸ *See* S. Rep. No. 494, 97th Cong., 2nd Sess. 266-69 (1982).

¹⁴⁹ *See United States v. Estate Preservation Serv.*, 38 F.Supp. 2d 846, 850 (E.D. Cal. 1998) (holding that because section 7408 expressly authorizes the issuance of an injunction, the traditional requirements for equitable relief need not be satisfied); *see also United States v. H & L Schwarz, Inc.*, 1987 U.S. Dist. LEXIS 14478 (C.D. Cal. 1987), *aff'd sub nom. Bond v. United States*, 872 F.2d 898 (9th Cir. 1989); *United States v. Music Masters, Ltd.*, 621 F.Supp. 1046 (W.D.N.C. 1985), *aff'd sub nom., without published opinion, United States v. Masters*, 816 F.2d 674 (4th Cir. 1987).

C. Standards of Tax Practice and Professional Conduct Regarding Tax Shelters

1. Circular 230 – Treasury regulations that govern practice before IRS

An individual who is a member in good standing of the bar of the highest court of a State may represent a person before the IRS.¹⁵⁰ Similarly, an individual who is duly qualified to practice as a CPA in a State may represent a person before the IRS.¹⁵¹ Individuals not qualifying under either the attorney or the CPA rules may represent a person before the IRS if they qualify either by passing an examination or by nature of their previous employment with the IRS.¹⁵²

The Treasury Department is authorized to regulate the practice of representatives before the Treasury Department (which includes the IRS), and (after notice and opportunity for a proceeding) to suspend or disbar any representative from practice before the Treasury Department for a violation of such rules and regulations. In accordance with this grant of authority, the Treasury Department has issued regulations that govern the practice of attorneys, certified public accountants, enrolled agents, and other persons representing clients (hereafter “practitioners”) before the IRS.¹⁵³ These regulations are commonly referred to as Circular 230.

Circular 230 contains rules governing the standards for certain tax shelter opinions, as well as rules governing the standards for advising a taxpayer to take a position on its return. The IRS Office of Director of Practice is responsible for the enforcement of Circular 230.

The Treasury Department recently proposed modifying and expanding the rules relating to tax shelter opinions. The proposed modifications will not become effective until they are adopted as final regulations. The following discussion first describes the current rules of Circular 230, and then describes the changes proposed with respect to tax shelter opinions.

Current rules under Circular 230

Standards for tax shelter opinions

Section 10.33 of Circular 230 provides specific rules regarding tax shelter opinions.¹⁵⁴ Section 10.33 requires a practitioner who provides a tax shelter opinion¹⁵⁵ to comply with the following requirements:

¹⁵⁰ 5 U.S.C. sec. 500.

¹⁵¹ *Id.*

¹⁵² Circular 230, sec. 10.4.

¹⁵³ 31 U.S. C. sec. 330. The regulations are found in Title 31, Part 10 of the Code of Federal Regulations.

¹⁵⁴ *See generally*, Bernard Wolfman, et. al., *Standards of Tax Practice* (5th ed. 1999) (hereinafter “*Wolfman, Holden & Harris*”), at 16-35, 98-102, and 400-411, for a detailed discussion of Circular 230.

- The practitioner must make an inquiry as to all relevant facts, be satisfied that the material facts are accurately and completely described in the offering materials, and assure that any representations as to future activities are clearly identified, reasonable, and complete. The practitioner cannot accept as true asserted facts pertaining to the tax shelter that the practitioner should not, based on the practitioner’s background and knowledge, reasonably believe are true. However, the practitioner is not required to independently verify the client’s statement of facts unless the practitioner has reason to believe that the facts are not true. Special rules are provided for tax shelters in which the fair market value of property or the expected financial performance of an investment is relevant.
- The practitioner must relate the law to the actual facts and, when addressing issues based on future activities, clearly identify what facts are assumed.
- The practitioner must ascertain that all material Federal tax issues have been considered, and that all of those issues which involve the reasonable possibility of a challenge by the IRS have been fully and fairly addressed in the offering materials.
- If possible, the practitioner must provide an opinion regarding whether it is more likely than not that an investor will prevail on the merits of each material tax issue in the tax shelter that involves a reasonable possibility of a challenge by the IRS. If the practitioner cannot provide such an opinion, the opinion should fully describe the reasons for the practitioner’s inability to so opine.
- If possible, the practitioner must provide an overall evaluation regarding whether the material tax benefits in the aggregate more likely than not will be realized. If the practitioner cannot provide an overall evaluation, the opinion should fully describe the reasons for the practitioner’s inability to so opine.¹⁵⁶ A favorable overall evaluation must be based on a conclusion that substantially more than half of the material tax benefits, in terms of their financial impact on a typical investor, more likely than not will be realized if challenged by the IRS.

¹⁵⁵ For this purpose, a “tax shelter” is an investment that has as a significant and intended feature for Federal income or excise tax purposes, deductions in excess of income, or credits in excess of tax liability, from the investment in any year to reduce income or offset taxes from other sources in that year. Certain types of investments are excluded (*e.g.*, municipal bonds, annuities, and qualified retirement plans). A “tax shelter opinion” is advice by a practitioner concerning the Federal tax aspects of a tax shelter either appearing or referred to in the offering materials or used or referred to in connection with sales promotion efforts (regardless of whether a separate opinion letter is issued or if the practitioner’s name is used).

¹⁵⁶ The offering materials must “clearly and prominently disclose” the fact that a practitioner cannot provide an overall evaluation (or that the overall evaluation is not favorable).

- The practitioner must assure that the offering materials correctly and fairly represent the nature and extent of the tax shelter opinion.

Section 10.33 also provides guidance regarding when a practitioner can rely on other opinions.

Standards for tax return advisors and preparers

Section 10.34 of Circular 230 provides specific rules regarding standards for tax return advisors and preparers. It states that a practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return “contains a position that does not have a realistic possibility of being sustained on its merits (the ‘realistic possibility standard’) unless the position is not frivolous and is adequately disclosed to the Service.” Similarly, a practitioner may not advise a client with respect to a position on a tax return (or prepare the portion of a return on which a position is taken) unless (1) the practitioner determines that the position satisfies the realistic possibility standard or (2) the position is not frivolous and the practitioner advises the client of any opportunity to avoid the section 6662 penalty by adequately disclosing the position. In any case, a practitioner has a duty to inform the client of any penalties reasonably likely to apply with respect to the position, and the opportunity to avoid such penalties through disclosure.

A position is considered to satisfy the realistic possibility standard if “a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.” A position is frivolous if it is “patently improper.”¹⁵⁷

Disciplinary actions under Circular 230

When the Director of Practice has reason to believe that a practitioner has violated any of the rules governing practice before the IRS, the Director of Practice can either (1) issue a private reprimand or (2) institute a formal proceeding for the disbarment or suspension of the practitioner.¹⁵⁸ A practitioner can be disbarred or suspended if he or she is shown to be incompetent or disreputable or refuses to comply with the rules of Circular 230.¹⁵⁹ In the context of tax shelter opinions, the term “disreputable conduct” includes (but is not limited to):

[G]iving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions . . . include those which reflect or result from a knowing misstatement of fact or law; from an assertion of a position known to be

¹⁵⁷ The definitions of the “realistic possibility standard” and “frivolous” are found in Circular 230, sec. 10.34(a)(4).

¹⁵⁸ The definitions of the “realistic possibility standard” and “frivolous” are found in Circular 230, sec. 10.34(a)(4).

¹⁵⁹ Circular 230, sec. 10.50.

unwarranted under existing law; from counseling or assisting in conduct known to be illegal or fraudulent; from concealment of matters required by law to be revealed; or from conscious disregard of information indicating that material facts expressed in the tax opinion or offering material are false or misleading.¹⁶⁰

Practitioners who violate the Circular 230 standards regarding tax shelter opinions can be suspended or disbarred only if the violation is willful, reckless, or a result of gross incompetence.¹⁶¹ The same standard applies to practitioners who violate the Circular 230 standards for tax return preparers and advisors. A private reprimand requires a showing that the practitioner's behavior constituted a violation of the Circular 230 standards. The Director of Practice also is authorized (but not required) to notify State authorities of the suspension or disbarment of an attorney or accountant licensed by the State.¹⁶²

Disciplinary action against a practitioner begins with a referral of professional misconduct to the Office of Director of Practice. Officers and employees of the IRS are supposed to make a referral if they have reason to believe that a practitioner has violated Circular 230. Moreover, the Internal Revenue Manual mandates an information referral upon the imposition of certain practitioner penalties.¹⁶³ The imposition of a substantial understatement penalty also may trigger a referral of the preparer to the Director of Practice.¹⁶⁴

The Director of Practice conducts an informal review to determine if (1) the practitioner is subject to the disciplinary jurisdiction of the IRS, and (2) whether the alleged behavior, if true, constitutes a violation subject to discipline. Following the informal review, the Director of Practice typically notifies the practitioner and provides the practitioner with an opportunity to respond to the allegations. If the Director of Practice institutes a formal proceeding for suspension or disbarment, the proceeding takes place before an administrative law judge whose decision can be appealed to the Secretary (and then to Federal district court). A special

¹⁶⁰ Circular 230, sec. 10.52(j).

¹⁶¹ Circular 230, sec. 10.34(b) and sec. 10.52.

¹⁶² Sec. 10.74 gives the Director of Practice the option of notifying the proper State authorities about the suspension or disbarment of an attorney or accountant licensed in that State. Apparently, the Director of Practice has entered into agreements with several State licensing authorities regarding the notification of the suspension or disbarment of an individual licensed in the State, and if requested, information regarding the disciplinary action (unless the disciplinary action was the result of a voluntary suspension or resignation). *See Wolfman, Holden & Harris, supra* note 154, at 34.

¹⁶³ I.R.M. Chapter 20(622)-1 provides that the assertion of practitioner penalties under sections 6700, 6701, 6695(f), 6694(a) and (b), 7407 and 7408, results in a mandatory information referral to the Director of Practice.

¹⁶⁴ I.R.M. sec. 4563.62(k) states that if a return prepared by an attorney, CPA, or an enrolled agent results in the assertion of the substantial understatement penalty, the attorney, CPA, or enrolled agent should be referred to the Director of Practice.

expedited suspension process exists for practitioners who have been convicted of a crime or have lost their license for cause.¹⁶⁵

Proposed changes to Circular 230

On January 12, 2001, the Treasury Department published proposed changes to Circular 230 and requested comments on these proposals.¹⁶⁶ The changes as proposed would not become effective until adopted as final regulations.¹⁶⁷

The proposals impose certain general standards, including rules with respect to the scope of an opinion and with respect to standards of care in the statement of facts upon which an opinion is based. In addition, the proposals establish two categories of tax shelter opinions, each subject to additional specific requirements.

“More likely than not” tax shelter opinions

Proposed section 10.35 would impose new standards for any tax shelter opinion that concludes that the Federal tax treatment of a tax shelter item or items is more likely than not (or at a higher level of confidence) the proper treatment. Section 10.35 would apply whether or not the opinion is rendered in connection with promotional efforts by a third party or directly to a potential tax shelter investor. Such an opinion must unambiguously conclude that the Federal tax treatment of the shelter item or items more likely than not (or at a higher level of confidence) is the proper treatment. A favorable overall conclusion may not be based solely on the conclusion that the taxpayer more likely than not will prevail on the merits of each material Federal tax issue.

The preamble to the proposals states that a “more likely than not” or higher level of confidence opinion potentially provides a basis for establishing reasonable belief and reasonable cause and good faith under the provisions of Code sections 6662 and 6664. It also states that the Treasury Department and IRS intend to modify the advice standards in the regulations under sections 6662 and 6664 to provide that tax opinions can satisfy the standards of reasonable belief

¹⁶⁵ These rules are found in Circular 230, secs. 10.50 - 10.76.

¹⁶⁶ 66 FR 3276 (January 12, 2001). On May 5, 2000, the Treasury Department issued an advance notice of rulemaking (65 FR 300375), requesting comments on amendments to the regulations relating to standards of tax practice governing tax shelters and other general matters. The January 12, 2001 proposals were issued after consideration of the comments received.

¹⁶⁷ The preamble states that the proposed rules would exclude opinions relating to municipal bonds and qualified retirement plans. The Treasury Department and IRS specifically requested comment on whether the regulations should exempt other transactions from the requirements for tax shelter opinions and, if so, what types of transactions should be exempted. 66 FR 3276 at 3279 (January 12, 2001). *See also*, Prop. Treas. Reg. sec. 10.35(e)(2).

and of reasonable cause and good faith, with respect to a tax shelter item, only if the opinions satisfy the standards of Circular 230.¹⁶⁸

The proposed regulations under section 10.35 state that an opinion that meets the stated requirements will satisfy the practitioner's responsibilities under that section, but the persuasiveness of the opinion with respect to the tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of law and regulations.

Other tax shelter opinions

In addition to setting new rules for "more likely than not" opinions, the proposals modify the scope of existing rules section 10.33 so that it would set standards for any tax shelter opinion not governed by section 10.35 (i.e., that does not express a "more likely than not" or higher level of confidence) and that a practitioner knows or has reason to believe will be used or referred to by others to promote, market, or recommend a tax shelter (whether publicly or privately).

The proposed rules would require clear and prominent first-page disclosure both of the absence of a "more likely than not" conclusion and that the opinion was not written for the purpose of establishing reasonable belief or reasonable cause and good faith under the provisions of Code sections 6662 and 6664. The practitioner would be required to reach an overall conclusion as to the likelihood that the Federal tax treatment of the tax shelter item or items is the proper treatment, or, where the practitioner is unable to reach such a conclusion, fully describe the reasons for such inability and on the first page of the opinion clearly and prominently disclose that the practitioner is unable to reach an overall conclusion.

Definitions

The definition of a "tax shelter" for purposes of these sections would conform to the definition used in connection with the imposition of an accuracy-related penalty.¹⁶⁹ A tax shelter opinion is written advice by a practitioner concerning the Federal tax aspects of a tax shelter item or items.¹⁷⁰ The term includes the Federal tax aspects or tax risks portion of offering materials prepared by or at the direction of the practitioner (whether or not a separate opinion is issued and whether or not the practitioner's name is referred to), as well as any financial forecast or projection prepared by a practitioner that is predicated on assumptions regarding Federal tax aspects of the transaction concerning any tax shelter item.

¹⁶⁸ See, the first and last paragraphs in the preamble regarding "more likely than not" tax shelter opinions, 66 FR 3276 at 3281 (January 12, 2001).

¹⁶⁹ See sec. 6662(d)(2)(C)(iii).

¹⁷⁰ In the case of an opinion subject to section 10.33, there is also a requirement that the practitioner know or have reason to believe the opinion will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending the tax shelter.

A tax shelter opinion does not include advice provided in connection with the review of portions of offering materials or sales promotion materials, provided neither the name of the practitioner or the practitioner's firm, nor the fact that the practitioner has rendered advice concerning the Federal tax aspects, is referred to in the offering or sales promotion materials.

A material Federal tax issue is any Federal tax issue the resolution of which could have a significant impact on a taxpayer under any reasonably foreseeable circumstance. In the case of an opinion that is not a "more likely than not" opinion, the proposals state that a material Federal tax issue includes the potential applicability of penalties, additions to tax, or interest charges that the IRS reasonably could assert with respect to the tax shelter item.

General standards for opinions

For any tax shelter opinion, the proposed rules require a practitioner who provides a written opinion with respect to a tax shelter item or items to comply with certain general standards, including:

- The practitioner must make inquiry as to all relevant facts and be satisfied that the opinion takes into account all relevant facts, and that material facts are accurately and completely described in the opinion.
- The opinion must not be based, directly or indirectly, on any unreasonable factual assumptions (including assumptions as to future events). An unreasonable factual assumption would include a factual assumption that the practitioner knows or has reason to believe is incorrect, incomplete, inconsistent with an important fact or another factual assumption, or implausible in any material respect.¹⁷¹
- If it would be reasonable based on all the facts and circumstances, a practitioner is permitted to rely upon factual representations, statements, findings, or agreements. A practitioner need not conduct an audit or independent verification of a factual representation, but reliance would not be permitted on factual representations that the practitioner knows or has reason to believe are unreasonable, incorrect, incomplete, inconsistent with an important fact or another factual representation, or implausible.¹⁷²

¹⁷¹ In the case of a "more likely than not" opinion, the proposed regulations state that an unreasonable factual assumption includes an assumption that the transaction has a business reason, an assumption that the transaction is potentially profitable apart from tax benefits, or an assumption with respect to a material valuation issue.

¹⁷² The proposed regulations state that a representation is incomplete, for example, if it states that there are business reasons for a transaction without describing those reasons, or if it states that a transaction is potentially profitable apart from tax benefits without providing adequate factual support. Also, a valuation is inconsistent with an important fact or factual assumption if it appears to be based on facts that are inconsistent with the facts of the transaction.

- Special rules are provided for tax shelters in which the fair market value of property or the expected financial performance of an investment is relevant.
- The opinion must clearly identify the facts upon which the opinion's conclusions are based, contain a reasoned analysis of the pertinent facts and legal authorities, and not assume the favorable resolution of any Federal tax issue material to the analysis or otherwise rely on unreasonable legal assumptions.
- The practitioner must ascertain that all material Federal tax issues with respect to the tax shelter item or items have been considered and that all of those material Federal tax issues involving the reasonable possibility of a challenge by the IRS are fully and fairly addressed. The opinion must state that the practitioner has considered the possible application to the facts of all potentially relevant judicial doctrines and as well as potentially relevant statutory and regulatory anti-abuse rules. The opinion also must analyze whether the tax shelter item or items are vulnerable to challenge under such doctrines and anti-abuse rules.
- The opinion must clearly provide the practitioner's conclusion as to the likelihood that a typical investor will prevail with respect to the merits of each material Federal tax issue that involves the reasonable possibility of a challenge by the IRS or clearly state that the practitioner is unable to reach such a conclusion. Further, the opinion would be required to fully describe the reasons for the practitioner's conclusions or fully describe the reasons for the inability to reach such a conclusion. In the case of a "more likely than not" opinion, a statement that the practitioner was unable to opine with respect to certain material Federal tax issues, including but not limited to whether the transaction has business purpose or economic substance, is not permitted.
- In ascertaining that all material Federal tax issues have been considered, evaluating the merits of those issues and evaluating whether the Federal tax treatment of the tax shelter item or items is the proper treatment, the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account.
- A practitioner would be required to take reasonable steps to assure that any written materials or promotional efforts that distribute, reflect, or refer to the tax shelter opinion correctly and fairly represent the nature and extent of the opinion.
- A practitioner must be knowledgeable in all aspects of Federal tax law relevant to the opinion being rendered. Rules are also provided for when a practitioner may rely on an opinion of another practitioner.

Sanctions

Under the proposals, The Secretary of the Treasury would be permitted to censure a practitioner after notice and an opportunity for a proceeding. This sanction would provide for a

public reprimand, in addition to the present ability of the Secretary of the Treasury to disbar or suspend a practitioner from practice before the IRS.¹⁷³

2. American Bar Association guidelines

The American Bar Association (“ABA”) has promulgated a series of rules and guidelines concerning the standards of practice for lawyers.¹⁷⁴ The ABA rules, in and of themselves, do not have legal effect. However, most States have adopted rules of professional conduct based on rules promulgated by the ABA (which have the force and effect of law). The two primary sets of rules that have been promulgated by the ABA are the Model Code of Professional Responsibility (“Model Code”) and Model Rules of Professional Conduct (“Model Rules”).

The ABA, through its Standing Committee on Ethics and Professional Responsibility, issues formal and informal opinions that interpret the Model Code and Model Rules. Of particular relevance to tax practitioners are (1) ABA Formal Opinion 346, regarding a lawyer’s duties and responsibilities in rendering tax shelters, and (2) ABA Formal Opinion 85-352, regarding a lawyer’s duty in advising a client on a position that can be taken on a tax return.

ABA Formal Opinion 346

Formal Opinion 346 (Revised), issued by the ABA Standing Committee on Ethics and Professional Responsibility in 1982, defines a lawyer’s duties and responsibilities in connection with tax shelter opinions that are offered as part of tax shelter investment offerings. The ABA does not have the authority to discipline its members for a violation of Formal Opinion 346; its application and enforcement is left to the State licensing authorities.

Formal Opinion 346 defines a “tax shelter opinion” as advice by a lawyer regarding the Federal tax law applicable to a tax shelter¹⁷⁵ if the advice is referred to either (1) in offering materials or (2) in connection with sales promotion efforts. A tax shelter opinion includes the tax aspects or tax risks portion of the offering materials prepared by the lawyer regardless of whether a separate opinion letter is prepared.

¹⁷³ Prop. Treas. Reg. sec. 10.50.

¹⁷⁴ For a more detailed discussion of the ABA Standards for lawyers, see *Wolfman, Holden & Harris, supra* note 154, at 85-95.

¹⁷⁵ For purposes of Formal Opinion 346, a “tax shelter” is an investment that has as a significant feature for federal income or excise tax purposes either or both of the following attributes: (1) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, and (2) credits in excess of the tax attributable to the income from the investment being available in any year to offset income from other sources in that year. Certain types of investments (*e.g.*, municipal bonds, annuities, and qualified retirement plans) are excluded from the definition.

A lawyer who provides a tax shelter opinion violates the disciplinary rules of the Model Code if the lawyer gives a false opinion.¹⁷⁶ A “false opinion” is one that ignores or minimizes serious legal risks or misstates the facts or the law, knowingly or through gross incompetence. A false opinion also includes (1) an opinion that is intentionally or recklessly misleading, and (2) the acceptance of facts as represented by the promoter, when the lawyer should know that a further inquiry would disclose that such facts are untrue.

Formal Opinion 346 also describes the principles and considerations that should guide lawyers in the rendering of tax shelter opinions. The lawyer should verify the facts presented to him and make further inquiries when the facts are incomplete, inconsistent, or otherwise open to question. The lawyer also should relate the law to the actual facts to the extent the facts are ascertainable when the offering materials are circulated, and not issue an opinion that disclaims responsibility for inquiring as to the accuracy of the facts, fails to analyze critical facts, or discusses purely hypothetical facts.¹⁷⁷ The lawyer should satisfy himself that either he or another professional has considered all material tax issues. Moreover, the tax shelter opinion should “fully and fairly address” each material tax issue for which a reasonable possibility exists that the IRS will challenge the proposed tax effects. The lawyer should, if possible, state his or her opinion of the probable outcome on the merits of each material tax issue, as well as an overall evaluation of the extent to which the tax benefits, taken as a whole, are likely to be realized (or not realized) as contemplated by the offering materials.¹⁷⁸

ABA Formal Opinion 85-352

ABA Formal Opinion 85-352¹⁷⁹ defines the basic ethical standard governing lawyers engaged in federal tax practice. It provides that “[a] lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no ‘substantial authority’ in support of the position, and there will be no disclosure of the position on the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification, or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated.”

¹⁷⁶ Formal Opinion 346 provides that a lawyer who gives a false opinion would have exceeded “the duty to represent the client zealously within the bounds of the law” (citing Model Code of Professional Responsibility DR 7-101). In addition, knowingly misstating facts or law violates DR 7-101, and is “conduct involving dishonesty, fraud, deceit, or misrepresentation,” in violation of DR 1-102(A)(4).

¹⁷⁷ The lawyer can assume facts that are not currently ascertainable so long as the assumptions are clearly identified in the offering materials, and are reasonable and complete.

¹⁷⁸ In general, an issue is considered “material” if the deduction or credit in question would have a significant effect in sheltering other income from taxes.

¹⁷⁹ ABA Formal Opinion 85-352, *reprinted in* 39 Tax Law. 631 (1986).

ABA Formal Opinion 85-352 represents a higher threshold than had been contained in the previous standard, as articulated in ABA Formal Opinion 314. The standard for tax practitioners under ABA Formal Opinion 314 required only that “a lawyer could freely urge the statement of positions most favorable to the client just so long as there [was] reasonable basis for the position.”

The standard in ABA Formal Opinion 85-352, which Congress adopted in 1989 as its model for income tax return preparers (section 6694(a)) is a lower standard than the “substantial authority” standard of section 6662(b)(2). A lawyer may advise the taxpayer to take a return position that does not meet the “reasonable possibility of success standard” provided that it is not frivolous and is either adequately disclosed or it is filed as a claim for refund. Thus, a lawyer is ethically permitted to advise the taxpayer to take a position on a tax return that subjects the taxpayer to the risk of the substantial understatement penalty.

3. American Institute of Certified Public Accountants guidance

The American Institute of Certified Public Accountants (“AICPA”) has not issued standards of practice specifically related to tax shelter arrangements. However, AICPA Statements on Responsibilities in Tax Practice (1991 Revision) represent general guidance for AICPA members, but do not constitute enforceable standards.¹⁸⁰ Rather, the statements are considered only educational and advisory in nature.¹⁸¹

The statements provide guidance for CPAs in recommending tax return positions and in preparing or signing tax returns, including claims for refund. Statement No. 1.02(a) provides that a CPA should not recommend a return position, or sign a tax return, unless there is “a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged.” In order to satisfy the realistic possibility standard, a CPA should have a good faith belief that the position is warranted by existing law or can be supported by a good-faith argument for an extension, modification, or reversal of existing law through the administrative or judicial process. The likelihood of audit or detection should not be taken into account in determining whether the realistic possibility standard is satisfied.

A CPA may recommend positions that are not frivolous so long as they are adequately disclosed on the return.¹⁸² A frivolous position is one which is knowingly advanced in bad faith and is patently improper. In recommending certain tax return positions, and signing returns, CPAs should advise the client of any potential penalty consequences and any opportunities that are available to avoid the penalties, such as through disclosure.¹⁸³ CPAs should not recommend

¹⁸⁰ For a more detailed discussion of the AICPA Statement on Responsibilities, *see Wolfman, Holden & Harris, supra* note 154, at 95-97.

¹⁸¹ The statements have been approved by at least two-thirds of the members of the Responsibilities in Tax Practice Committee and the Tax Executive Committee.

¹⁸² AICPA Statement on Responsibilities in Tax Practice (hereinafter “Statement”) No. 1.02(c).

¹⁸³ Statement No. 1.02(d).

tax return positions that are intended to exploit the IRS tax return audit selection process or serve as mere arguing positions advanced solely to obtain leverage in the bargaining process of settlement negotiations with the IRS.¹⁸⁴

4. State licensing authorities

Each State, by virtue of the State courts (for lawyers), or through a licensing board (for CPAs), regulates and disciplines practitioners who are authorized or licensed to practice in the State. Many State regulatory bodies maintain rules that mirror the standards of national organizations, such as the ABA and the AICPA. Tax practitioners that fail to abide by their respective State requirements may be subject to disciplinary actions, such as disbarment, suspension, reprimand, or denial of license to practice within such State.

¹⁸⁴ Statement No. 1.03.